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AUDITING

A PRACTICAL MANUAL FOR AUDITORS

By

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CONTENTS

	PAGE
Statement by the Author of the English Edition,	4
Preface to the American Edition,	5
Preface to the Second American Edition,	8
Introduction by A. Lowes Dickinson,	11
I.—Introduction,	17
II.—Methods of Account,	55
III.—Special Considerations in Different Classes of Audits,	90
IV.—The Same (*Continued*),	132
V.—The Same (*Continued*),	158
VI.—From Trial Balance to Balance Sheet,	168
VII.—Form of Accounts and Balance Sheets,	208
VIII.—What are Profits?	246
IX.—The Attitude of the Auditor,	266
X.—The Liabilities of Auditors,	290
XI.—Investigations,	315
XII.—Interest,	342
Appendix A. Legal Liability of Auditors, Legal Decisions, &c.,	356
Appendix B. Professional Ethics,	380
Appendix C. American Malting Case,	386
Appendix D. Forms of Accounts,	396
Appendix E. C. P. A. Examination Questions,	510
Appendix F. Extract from "Tretyce off Housebandry,"	537
Appendix G. United States Corporation Tax Law of 1909	540

AUTHORIZATION.

To avoid misunderstanding I have thought it desirable to append a note to this volume, pointing out that it has been issued by arrangement with me, and that the various alterations and amendments that have been effected, with a view to making the work more suitable to the needs of American practitioners and accountant students, have all been submitted to me and have met with my entire approval.

The numerous extracts from Acts of Parliament that appear in the English Edition have been omitted, and the somewhat voluminous reports of British legal decisions have been materially condensed; but the alterations in the body of the work are only such as appeared to be called for under the circumstances, and while condensation has taken place in some directions, in others the scope of the work has been considerably elaborated.

I trust that the production of this Americanized Edition of my work will add to the popularity that it has already earned in the States during the past seventeen years.

LAWRENCE R. DICKSEE.

COPTHALL HOUSE,
LONDON, E. C.,
ENGLAND.
24th September, 1909.

PREFACE TO THE AMERICAN EDITION.

It cannot be expected that any hard and fast rules will ever prevail, nor is it desirable that the personal element in an audit should be superseded by instruction prepared in advance, but it must be admitted that the experiences of one professional Auditor are of great value to others. It is the object of this work, therefore, to state as concisely as possible, the results of Mr. Dicksee's experience supplemented by suggestions from leading English and American accountants, and it is believed that some portion of this book, at least, will be found valuable to every American practitioner and student.

Much of the matter herein contained is taken verbatim from Mr. Dicksee's English edition, which for many years has been the standard work on Auditing both in Great Britain and America. The principal changes, therefore, are those which are caused by the numerous differences existing between accountancy nomenclature, laws and customs of Great Britain and the United States.

The interchange of thought which has followed the various meetings of the English Societies, and which has been of great value to the profession at large, had no counterpart in the United States until the holding in September, 1904, of the Congress of Accountants at St. Louis. Discussion of the papers read on various accountancy topics did much to em-

phasize the importance of a better understanding among accountants, particularly along the lines of uniform methods of preparing and stating accounts. These suggestions covered not only municipal and public service corporation accounts, but embraced general methods as well.

We find ourselves, therefore, at the very threshold of what may be called a new era in the profession in the United States, and we are fortunate in having the benefit of the best English practice as a guide to our broadened field. We must recognize, however, the wide differences between our laws and customs, and, while the essential principles underlying all properly conducted audits are the same, yet it may be found hereafter that more radical modifications in Mr. Dicksee's text will be in order.

References made herein to American customs are based on my general practice and observations covering a number of years, but no claim is made, of course, that the field has been sufficiently covered to warrant the statement that the last word has been said on any subject of which mention is made. On the contrary, it can only be hoped that the necessity for a somewhat better understanding as to "good practice" than has heretofore existed will be recognized.

I take this opportunity to express my indebtedness to several members of the profession for valuable suggestions received. In particular I desire to express my thanks to Arthur Lowes Dickinson, M.A., F.C.A., C.P.A., and to my partner, William M. Lybrand, C.P.A.

As a fitting conclusion, nothing better expresses my thought than the last clause of the Preface of Mr. Dicksee's first English Edition:—

"As I have no claim to completeness in this work, so also do I wish to disclaim any assumption of absolute finality; and, accordingly, I shall consider myself greatly indebted to my readers for any suggestions and opinions with which they may be pleased to favor me, which, I need hardly add, shall receive every attention upon the publication of a new edition."

ROBERT H. MONTGOMERY.

43 EXCHANGE PLACE,
NEW YORK.
25th August, 1905.

PREFACE TO THE SECOND AMERICAN EDITION.

During the four years which have elapsed since the publication of the first American edition of this work, four thousand two hundred and fifty (4250) copies have been printed.

Its reception was very gratifying and it is to be hoped that the present edition will be received as kindly.

The entire text of the first edition has been revised, but no material changes have been made in the general principles which, as enunciated by Mr. Dicksee and again reprinted, represent the best thought of the profession here and abroad.

Within a few years there has been a considerable advance with respect to standard forms of accounts and it seemed wise to reproduce a number of them in this volume.

Other new matter also appears, all of which is submitted with the hope that it may prove of interest to members of the profession and of practical assistance to students.

I am indebted to Walter A. Staub, C. P. A., for his services in connection with this edition, particularly with reference

to the chapter on Interest and the Discussion of the Corporation Tax Law.

I wish to repeat the statement which will be found in the preface to my first edition, viz.: "I shall consider myself greatly indebted to my readers for any suggestions and opinions with which they may be pleased to favor me."

ROBERT H. MONTGOMERY.

165 Broadway,
New York.
2d December, 1909.

INTRODUCTION.

BY ARTHUR LOWES DICKINSON, M.A., F.C.A., C.P.A.

The publication of an American edition of Mr. L. R. Dicksee's work on Auditing is further evidence of the growing importance to the community of a correct understanding of the principles of Accounting; and the fact that this edition has received the support of educational authorities throughout the country is full of promise for the future of the still young profession of the Public Accountant.

Bookkeeping is a simple science, and complete mastery of its principles does not call for any very high order either of intelligence or of education. Bookkeeping, however, is only one, and perhaps the smallest, of the necessary qualifications for the Public Accountant who would succeed in his profession.

The question is daily asked—What is a Public Accountant? And the answer that best defines his place in the world of Commerce may, perhaps, be expressed as follows: A Public Accountant is a person skilled in the affairs of Commerce and Finance, and particularly in the accounts relating thereto, who places his services at the disposal of the community for remuneration. This definition calls for three main qualifications:—

(1) Skill in the affairs of Commerce and Finance.

(2) Special skill in the Accounts relating thereto.

(3) The application of this skill to the affairs of the community, and not merely of one Corporation or Firm, for remuneration.

In Great Britain the Public Accountant has during the past quarter of a century worked out his own salvation, and is regarded as a skilled Commercial and Financial Advisor, not only on accounts, but upon general business matters. While he is frequently appointed to such positions of Trust as Liquidator, Receiver, &c., which in this country are either awarded for political reasons or to Lawyers, his main duties consist in the audit of the accounts of Corporations, Firms and Individuals, and it is to this branch of the subject that the present volume mainly relates.

The Public Accountant acting as a Professional Auditor must be familiar with the general principles of Commercial and Common Law, including that relating to Corporations, Bankruptcy and Trusts; he must be acquainted with Economic and Banking principles; and with those underlying the valuations of property of all kinds. But his knowledge of all these subjects is a means to an end, and that end is the application thereof to that one subject of Accounts in which his skill specially lies; while on the more complicated Legal, Economic or Valuation questions he must, and does, consult those other business Advisors who have special skill in these matters. There is probably no other profession, not even excepting that of Law, which requires of its members, if they would succeed, a higher standard of education, experience and general business knowledge.

Within recent years the degree of Certified Public Accountant has been created by certain States. The future value to the Profession of this degree is exactly what its members make it, and no more. The holders are placed in a privileged position, which is of value only so far as by their own honesty and ability they can maintain a standard superior to those who have not so qualified. The future is with the rising generation, and the various Schools of Commerce connected with Universities all over the country are doing excellent work in the provision of educational facilities. As the educational standard is raised, as the class of college men from

whom the legal profession is at present so largely recruited is attracted to the profession of Public Accountant, so will the standard be raised to a yet higher level, and the profession will gradually obtain that full and complete recognition already obtained in England, but as yet very grudgingly and only to a small degree accorded in America.

The moral qualities called for are so high that it should place the profession at the head of all which come into contact with business affairs. The Lawyer's duty is first of all to his client, and that duty frequently compels him to avail himself of technicalities and other means of enabling that client to evade the Law and its penalties; but the Public Accountant has only one duty to his client and to the Public, and that is to disclose to him or for him "the truth, the whole truth, and nothing but the truth," so far as his abilities and special training to that end enable him to ascertain it. No legal quibbles will save him from moral condemnation if he fails in this duty; no juggling with words and phrases will absolve him from responsibility, moral and often legal, for results which he has reason to know are not what they seem to be, or which, having regard to his special training in business affairs and the accounts relating thereto, he ought to have known did not represent the facts. Errors there may be and must be and for errors made after full and proper precaution taken and due care exercised no responsibility will lie. But there is no profession in which the results of careless errors or misstatements will more certainly bring retribution.

While differences of opinion on matters of principle must always exist, perhaps they exist to a less extent in Accountancy for the reason that most of its problems when attacked with intelligence admit of being carried back to elementary first principles. The faculties requisite for such a mental exercise are the result of thorough training and long experience coupled with a mind naturally gifted with analytic powers; and having regard to the variety of problems which arise, the first principles or admitted facts necessary to their solution are

themselves very numerous. The best preliminary training would seem to consist in the acquirement of a thorough knowledge of these principles or facts throughout the domain of Mathematics, Economics, Banking, Law and Commerce; the practical application of these principles to the special science of Accounting naturally follows, and the present volume may be described as an elementary text-book on the practical side of the question. If the student would avail himself thoroughly of it, he must analyze every proposition therein to its elements, search out the economic, legal or commercial reasons for it, and so fit himself to pass judgment upon the actual facts which may come before him in his wider practice in the Commercial world.

The Public Accountant so trained who will apply his whole mental energies to the problems before him, and arrive at a solution unbiased by any outside influence,and confident in his own ability, and above all integrity, need have little fear of the pains and penalties described in the Chapter on the Auditor's responsibility.

AUDITING.

CHAPTER I.

INTRODUCTORY.

AUDITING (up to the Trial Balance).

PRELIMINARY CONSIDERATIONS.

Before touching on matters of detail it may be well to observe that the sole purpose of this book is to treat of an audit from the standpoint of the professional auditor and the student who have mastered the principles of bookkeeping, and it is, therefore, not deemed necessary to discuss nor define "Auditing" in the abstract.

It is obvious, too, that the preliminary stages of arranging for the work, settling upon its scope, and the general attitude of the auditor are all matters which appear for examination more logically in later chapters.

For some years it has been the custom of leading firms of accountants, both in England and America, to use a small note book for each audit on which they are engaged.

The form usually preferred consists of a book with printed instructions of a general nature in front, followed by several blank pages for special instructions applicable to the particular audit, and for memoranda to be written up during successive audits.

Specially ruled pages are then provided. Each page is used to record the work done on one book or class of accounts, and enough sheets should be bound in each book to allow for recording the memoranda of the audit of a large undertaking. The pages are printed and ruled somewhat as follows:

GENERAL CASH	12/31/09		6/30/10		12/31/10		6/30/11		12/31/11		6/30/12		12/31/12		6/30/13	
Count cash on hand																
Prove balance first of month																
Verify bank balances																
Examine vouchers																
Verify footings																
Petty cash transfers																
Cash sales "																
Postings debits																
" credits																

The most convenient book is one in which each page is ruled with twelve double columns, thus providing for the record of a year's work where the audits are made monthly, six years' work where they are made semi-annually, etc. The columns are arranged so that the date of completing each part of the work may be recorded as well as the initials of the audit clerk.

Since the issue of the first American edition of this work, the Accountancy Publishing Co. has published an "Audit Note-Book," the demand for which is sufficient to prove that the use of such a book is very general among the profession.

On the other hand, it has been suggested "that if a competent clerk is sent to undertake an audit (and none but competent clerks should be sent), it is much the better way to leave him unfettered with printed instructions, but allow him to go thoroughly into the whole system in operation, and from the nature of such system, and from what he sees, let him outline his own method of procedure. By this means there is not so much danger of his getting into a semi-careless groove of working, and, moreover, he feels that more responsibility is placed upon him, which acts as an incentive to do the work more thoroughly than would be the case were he working to 'rule of thumb.'" There is, doubtless, something to be said upon this side of the question; but if so much be left to the clerk, it is a little difficult to see what the principal is expected to do himself. In any case, however, the book is useful as a record of the routine work performed and of the queries raised in the course of audit. It is believed that, in point of fact. some sort of audit note-book is almost invariably used by most accountants at the present time.

The printed instructions cannot be more than a mere outline of an auditor's duties, but they can be so framed as to be of material assistance to the audit clerks.

The following instructions are modelled after a set used in an English office for many years, and will be found extremely

suggestive. Various modifications of these instructions appear in most audit note-books. It is understood, of course, that no attempt is made to lay down any hard and fast rules.

INSTRUCTIONS FOR AUDIT.

1. In commencing a new audit obtain a list of all the books kept, and of all persons authorized to receive or pay money and order goods.

2. In the case of a corporation, examine the by-laws and board minutes respecting the receipt and payment of money, and the drawing of cheques, notes, &c.

3. Ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid, and whether they are paid exclusively or generally by cheques.

4. Report if the accounts and vouchers have been systematically checked and certified; and note any discrepancies.

5. Compare the cancelled cheques with the cash payments. Compare a portion of the items of deposits, as detailed in cheque stubs or copy-book, with the receipt side of the cash book, to determine whether all items deposited have been properly entered. Prove the reconciliation of the cheque book balances at the end of the period with the bank pass books, and see that the latter are frequently balanced and examined.

6. Note any unusual or extraordinary payments or receipts.

7. In regard to the payments for wages and petty cash, note any unusual items, and see that vouchers for all other payments are kept and produced.

8. In all cases where branch establishments are included in one business, you will be careful to examine into the mode of bringing the returns of operations, accounts, and expenses to the head office.

9. Examine the purchase and sales books, and see that the proper returns of purchases and sales are made by each department; that the purchase and sales books are properly entered up; that the invoices are properly checked as to quantities and prices; satisfy yourself that every liability of the year is brought into the accounts.

10. Ask for special instructions as to how far the postings and footings of the individual ledgers and the footings of the books of original entry are to be verified.

11. All the postings in the nominal or general ledgers must be checked. The mode of the journalizing must be carefully examined and its correctness tested.

12. Verify the trial balances of all ledgers, being careful not to omit the comparison of the totals of those of subsidiary ledgers with the controlling accounts in the general ledger trial balance.

13. Examine the bills receivable and bills payable books, and note any item of past due, renewed or protested notes, and make list of same and of the collateral security, if any.

14. Examine the entries and transfers passed through the journal, and check the postings; and although you are not held responsible for the details of classification, it is desirable you should make any suggestions required, and note any discrepancies, especially in relation to the division thereof on account of capital and revenue accounts respectively.

15. Ask for special instructions as to examination of capital stock and mortgage bond accounts.

16. In the accounts of stock-taking see that all stock sheets and returns are duly signed by the heads of departments, and that the same are correctly carried forward to the general inventory account; and ascertain and note whether goods finished or in progress are taken at cost price or otherwise; also in large concerns report whether an independent clerk has verified the stock returns in regard to prices and quantities.

17. In checking the profit and loss account, note whether the usual and proper deductions have been made for wear and tear and depreciation.

18. Take care that in the balance sheet no additions are made to expenditure on capital account, except such as are authorized or passed upon by some responsible person, and note the distinction between new works and mere replacements.

19. Ascertain the correctness of the cash balances, promissory notes, and other securities in hand. Take note of any items or memoranda carried as cash.

To sum up, then, the matter may be stated thus:—At the commencement of an audit the principal should if possible, go over the ground personally, and decide what work requires to be done. A list of such work (together with any other special notes that may seem desirable) should be entered in the audit note-book, which should be ruled in columns, so that the initials of a clerk against any item may clearly show that he is responsible for the correctness of that item for the

period named at the head of the column. As heretofore mentioned, it is practicable to keep books ready printed which, with but slight alteration, will answer the purposes of any audit; but there will usually be some special circumstances connected with each audit that distinguish it from others, and these circumstances will usually involve some modification of the customary routine obtaining to that class of accounts.

Some sort of definite system is undoubtedly preferable to leaving things too much in the hands of the audit clerk, as there is, in the latter case, always a danger, either of dissatisfying the client, or else of leading him to prefer a change of principals to a change of clerks, if one of the two be inevitable. For this reason, if for no other, the principal should always endeavor to keep the reins of every audit in his own hands, or, at least, out of the exclusive control of any one audit clerk; for, although objection may legitimately be taken to the latter being kept at a continual game of "General Post," it cannot be denied that it is a mistake to invariably send the same clerks to the same audits.

THE OBJECT AND SCOPE OF AN AUDIT.

The next point to be considered is the object and extent of an audit. The object of an audit may be said to be threefold:

(1) THE DETECTION OF FRAUD.
(2) THE DETECTION OF TECHNICAL ERRORS.
(3) THE DETECTION OF ERRORS OF PRINCIPLE.

On account of its intrinsic importance the detection of fraud is clearly entitled to be considered an "object" in itself, although it will be obvious that it can only be concealed by the commission of a technical error or of an error of principle. It will be appropriate, therefore, to combine the search after fraud with search for technical and fundamental errors; but it can never be too strongly insisted that the auditor *may* find fraud concealed under *any* item that he is called upon to verify.

His research for fraud should therefore be unwearying and constant.

It has been asserted by some that the whole duty of the auditor is to ascertain the exact state of his client's affairs upon a certain given date. This is, in effect, the same thing as saying that he is only responsible for the correctness of the balance sheet. Even if this be the case—and it is open to considerable doubt, as the extent of an auditor's duties depends entirely upon the terms of the express or implied contract between himself and his client—the balance sheet cannot well be verified without a proper examination of the revenue account, which in its turn involves a complete examination of the books.

The detection of fraud is a most important portion of the auditor's duties, and there will be no disputing the contention that the auditor who is able to detect fraud is—other things being equal—a better man than the auditor who cannot. Auditors should, therefore, assiduously cultivate this branch of their functions—doubtless the opportunity will not for long be wanting—as it is undoubtedly a branch that their clients will most generally appreciate.

Before dealing with the various methods to be adopted to insure the detection of errors, it will perhaps be not out of place to inquire what is the *extent* to which an auditor is expected to carry his research. This will naturally vary according to the circumstances of each individual case; but even allowing for this, the greatest diversity of opinion obtains, some claiming that an auditor's duty is confined to a comparison of the balance sheet with the books, while others assert that it is the auditor's duty to trace every transaction back to its first source. Between these two extremes every shade of opinion may be found; and, among others, the opinion of most practical men. Were the auditor's functions limited to a certification that the balance sheet submitted to him was in accordance with the books, it would be difficult to conceive why the

amateur auditor should have been found so lamentably wanting: on the other hand, it cannot be denied that (except in concerns of comparative insignificance) a minute scrutiny of *every* item would be quite impossible to the auditor—nor indeed is such a detailed audit often necessary, although it is in the highest degree desirable that every undertaking should possess the means of enabling the *staff* to make such an examination for itself.

In undertakings where the transactions are too numerous to justify checking every entry, it is usually possible to test the accuracy of the bulk of the work by aggregates which appear in subsidiary books and ledgers, and which are represented in the general or private ledger by controlling accounts.

This is a matter that will be dealt with at some length later on, and its further consideration may be postponed until that time.

It is in the highest degree necessary that the auditor, before commencing his investigation, should thoroughly acquaint himself with the general system upon which the books have been kept.

In England it is customary in most cases, and compulsory in others, for the auditor to be supplied with a list of the books in use, but in this country the list is in nearly all cases either not supplied at all or else it is made by the auditor himself during the progress of the audit. Such a practice is, indeed, very desirable. It cannot be too strongly insisted, however, that such a list can only be of any real utility when the auditor thoroughly grasps the uses, and the possible abuses, of which each book is capable. Numerous instances have been known of an audit entirely failing through neglect of this precaution.

Having thoroughly made himself master of the system, the auditor should look for its weakest points. "Where is fraud most likely to creep in?" he should ask himself; and, if he

can find a loop-hole, let him be doubly vigilant there. But never let him for a moment suppose that, because he sees no opportunity for fraud, none can exist. To the intelligent auditor who has grasped his system thoroughly, it is generally practicable to dispense with a considerable portion of the mechanical means of checking. To what extent this can be done with safety must always remain a question for each auditor's own intelligence and experience to answer, and it may be added that probably he must take the risk of any consequences that may ensue; but—so far as the matter can be explained in a general treatise—its solution will be sought after in these pages.

Before leaving this subject, it may, perhaps, be well to add that, under the expression "mastery of the general system," perusal of the partnership agreement, the charter and by-laws of a corporation, recorded contracts and agreements, State laws, and any and all other documents that, *per se,* affect the general constitution of the concern, are included.

ADVANTAGES OF AN AUDIT.

The question has been raised from time to time as to what advantages may be reasonably expected from a proper professional audit of accounts. In addition to those mentioned, as coming under the head of the primary objects of auditing, it may be pointed out that the proprietor or proprietors of a business will not only have the advantages of having placed before them an accurate statement of their affairs, together with a profit and loss account showing how this position has been arrived at, but that they would also have available certified accounts as to profits which cannot fail to be of the greatest convenience, in the event of their wishing to sell the business to a private trader, or firm, or to an incorporated company, or in the event of one of the partners dying or wishing to retire, or for the purpose of submitting a statement to banks as a basis for loans. One of our most eminent New York bankers in an address to a bankers' convention advised those

present to require prospective borrowers to furnish statements prepared by Certified Public Accountants, and at the convention of the American Bankers' Association, held at Denver, Colorado, in the autumn of 1908, the Committee on Credit Information reported, urging "that every member exert his influence to have all paper purchased from note brokers presented with accompanying statements audited by Certified Public Accountants . . ." and to that end asked that the Association, by the adoption of the Committee's report, "recommend that its members in purchasing commercial paper from note brokers, give preference to such names as furnish accompanying statements audited by Certified Public Accountants. . . . " Under each of these circumstances the importance of a thoroughly reliable statement of profits cannot well be over-estimated, and the convenience it affords—as well as the enhanced price which can be obtained in the event of a sale—will under all normal circumstances more than compensate for any slight expense which the audit may have originally involved. It is, of course, quite clear that one of the reasons an enhanced price may be obtained is that in considering an ordinary statement of profits, no matter how carefully it may be prepared it is usual to "discount" the results, while an audited statement can be safely taken at its face. So far as private firms are concerned, an efficient audit possesses the further advantage that, by reason of its insuring a periodical preparation of reliable accounts, it tends to minimize the risk of partnership disputes, with all their attendant annoyance and expense. Accurate accounts are also of great value to both sides in compensation cases.

In the case of corporations the audit assumes a slightly different aspect. The company auditor is not expected to act as the financial adviser of the undertaking—a position that is frequently thrust upon him in connection with private audits—his duty being rather that of an auditor appointed in the interests of an inactive partner. It devolves upon him to examine the accounts of their stewardship, prepared by the active part-

ner—*i. e.*, the directors—and to state whether in his opinion those accounts are correct, and fully and fairly disclose the position of affairs, or in what respects they fail to do so.

In addition, it may be pointed out that an auditor, through gross negligence, failing to discover fraud or embezzlement on the part of the employees of the client, may possibly be held liable in damages for the amount lost as a result of his negligence. While no cases bearing on the specific liability of auditors have been decided by any of the higher courts in the United States, the law is very well settled in England that auditors are liable for gross negligence. The leading English cases are cited in Appendix A to this work, and in the absence of American decisions our courts can be expected to follow them. If they do not, however, they will seek analogous cases on our own books, and, as will be more fully explained in a later chapter, our courts are reasonably sure to hold auditors strictly accountable.

This liability involves, of course, a corresponding benefit to the persons in whose favor the liability accrues, and is consequently a factor that ought not to be lost sight of in weighing the advantages of an audit. It is, however, hardly necessary to add that the auditor does not insure the honesty of his clients' employees.

There does not seem to be any general realization on the part of many auditors of the responsibilities they assume when they undertake to audit the accounts of large concerns for an extremely small fee—frequently fixed in advance—and which on its face does not allow for more than a mere skimming of the affairs of the company. It would, therefore, be no great calamity to the profession as a whole to have an American decision definitely settling this vexatious question.

Needless to say, there is no desire on the part of any American practitioner to be the first victim, and it is hoped that with a more general knowledge of the full duties and respon-

sibilities of professional auditors the standard will be raised to a point where no severe consequences can follow.

METHOD OF AUDIT.

A comparison of the relative merits and disadvantages of completed and continuous audits is worthy of more attention than it has hitherto attracted.

THE CONTINUOUS AUDIT sometimes includes the preparation of the periodical accounts by the auditor's staff. Its advantages may be said to be: (1) The examination occurs sooner, and consequently any errors committed are more quickly detected and rectified; (2) the periodical visits of the auditor keep the bookkeeper closer up to his work; (3) a more detailed audit is practicable; (4) the audit can be completed soon after the closing of the books, without unduly hurrying the examination. On the other hand, there is always a danger of items that have been checked by the auditor being altered (either ignorantly or fraudulently) before the final audit; and it is therefore necessary that the clerk in charge of a continuous audit be very wide awake, and have a very clear idea of the system under which he is working.

It has been found a good plan to adopt a special "tick" for the verification of all figures upon which a correction appears; as, if this plan is adopted, a correction made after the tick has been affixed will be more readily discovered. It goes without saying that the difference in the two ticks should be as slight as possible, and the bookkeeper should *not* be told what the difference implies.

THE COMPLETED AUDIT (by which is meant the audit begun after the trial balance has been completed) obviates this difficulty to a certain extent, and, if the books remain in the auditor's sole custody during the duration of the audit, entirely; but the drawbacks it presents (which are, naturally, the advantages of the continuous audit) render its adoption impracticable, except in small concerns or in partial audits, unless the

books can be so arranged that very little detailed checking has to be done by the auditor.

The risks involved in leaving the books in the hands of the bookkeeper during the audit are undoubtedly very considerable; but, so long as these difficulties are not lost sight of, there is but little doubt that common-sense and a general alertness will save the auditor from this—as well as many another —danger. Moreover, where the auditor himself closes the books—and this will not infrequently be the case in small audits conducted continuously—it should be difficult for fraud on the part of the staff to altogether escape detection.

It would be well to mention here the extreme importance of *completing* each item of the audit as soon as possible after it is begun. Extensive frauds have escaped detection because the auditor checked the balances of a ledger one day and the additions of such balances on the next—some of the items having been altered in the meantime. It will be obvious that had the additions been checked on the same day as the extraction of the balances, and a note taken of the total, the fraud would have been impossible.

What may be described as the "ideal" audit is one combining the two modes of investigation just described. It is sometimes attained in England by the employment of two independent auditors, one performing a continuous and the other a completed audit; but more frequently the continuous audit is done by "staff" auditors, or by the client's ordinary employees under a good system of internal check.

CALLING BACK POSTINGS.

Having now cleared the ground of various preliminary considerations, the manifold points arising in the course of an ordinary audit will be dealt with.

It has been seen that, in every instance, it will be necessary for at least some of the postings to be called over; and inasmuch as by that means the auditor will at once acquaint him-

self with the nature of the transactions that have occurred, the calling back of such postings will form an appropriate starting-point for examination. Many persons prefer to start with an examination of the vouchers, and, if the vouchers are rich in detail, it will frequently be desirable to take them first; but when—as is often the case—they are mostly bare receipts for so much money, it will generally be best to start with the postings.

It is well to commence with the posting of the cash book, even when all the postings are to be checked, as by this means a general idea of the business done is most quickly grasped; which is very desirable. As a general rule the postings should be called back from the ledger, as it is not only more rapid as a rule, but in cases where cash credits have been made in the ledger without a corresponding debit to cash the fraudulent entries are more quickly discovered. The calling over of postings can hardly be too carefully done, and although the work is decidedly mechanical—and, consequently, somewhat somniferous—it must be most conscientiously performed. In particular, care must be taken not to pass any item already ticked, unless it be certain that it has inadvertently been ticked in the regular course of audit; and also any items remaining unticked after the calling over is completed should receive most careful attention. Inexperienced clerks are apt to "suppose" they ought to have ticked an item, or to "suppose" they ticked such-a-one instead of such-another. Either "supposition" may cause a fraud to remain undetected, or (which will, perhaps, appeal to the youthful mind more powerfully) may keep him late at his work night after night, while the senior audit clerk hunts up and down for an error in the trial balance. When the error is discovered to be a mistake in the posting that was passed in calling back, it is possible that the unfortunate junior will be even more sorry that he ever ventured to "suppose."

Where it is intended to check every posting, it is a good plan, after the cash postings have been checked, for the remain-

ing postings to be called back from the ledger into the journals, etc.; and it will probably save time, while going through the ledgers, to check the additions and balances at the same time, and so finish each ledger at a sitting. This method, however, is not always convenient, or even possible, and much must therefore be left to the discretion of the clerk in charge.

Where there are subsidiary books from which very few postings are made to the ledgers, they can be exhausted before going through the ledger a second time to clean up. For instance, with a journal having but a few entries the first item can be called from the journal to the ledger, and then all subsequent journal entries in that same ledger account will be called back; after they are completed the second item in the journal should be taken up, and so on until the journal is exhausted.

It is not always easy to impress upon the clerks the importance of so gauging the work that both men will be busy practically all the time, and if this is not watched closely we may find one clerk going through an entire ledger for an entry or two while the other clerk sits patiently or sleepily by doing nothing!

BAD OR AMBIGUOUS FIGURES should always receive close attention, as it not infrequently happens that they are posted as one figure, and added up as another. Corrections, too, require careful attention. Erasures should always be strictly prohibited; and where hand-made paper is used for books, they should be keenly watched for, as a clean erasure may easily have been made. It is very important that the room used by the auditors be well lighted, or mistakes may easily occur. Where a correction has been made, care must be taken to insure that the addition and posting have both been altered. In a continuous audit this is especially important, but—as it has already been noticed—it need not now be dilated on.

It may seem almost superfluous to say that the clerk calling back should always speak clearly, but experience teaches that

this is a matter that frequently does not receive the consideration it deserves. Such a mistake as $200.25 being posted $225.00 should be guarded against by always mentioning the word "cents" in calling back such an amount. It is important that the clerk calling should learn to "pull with" the one who is turning over folios. This is a habit much more readily acquired by some juniors than others—in many respects it resembles the art of accompanying in music—and the senior who has found a youngster to suit him will not willingly make a change, as the economy of nervous force consequent upon perfect accord is very considerable.

VERIFYING ADDITIONS.

In all cases it is desirable, although it is not always practicable, that all the additions should be verified. In every case, however, the additions of the private ledger, general ledger, cash books, sales books, petty cash books and payrolls will require to be verified in detail unless the auditor can satisfy himself as to their accuracy by intelligent and comprehensive tests. This should always be done when the other work connected with the same book is being done; for if the designing bookkeeper has power to make alterations meanwhile he can afford to laugh at every safeguard against fraud.

It is hardly necessary to add that the verification of additions though purely mechanical is most important work. It is especially necessary that the "carried forwards" be checked on to the following page, as errors frequently occur here. Also when verifying the additions of a book with several columns of figures it is important to see that the distinction between the various columns is preserved when carrying forward totals from one page to another.

THE PREVIOUS BALANCE SHEETS.

While the junior clerk is checking additions, the senior will have time to see to many matters which require his attention.

Foremost among these will be the comparison of the ledgers with the last balance sheet—unless, indeed, the principal has already dealt with this point.

It is very generally conceded that no auditor can be made liable for the acts or omissions of his predecessor in office; but this rule must, of course, be strictly applied, and an auditor who adopts and perpetuates the mistakes of his predecessor would not on this account alone escape the consequences of his own negligence. It is important, therefore, to carefully scrutinize those items which, in the ordinary course, are brought forward as balances from one year to another. In so far as their correctness cannot be tested by an examination of the accounts under review, the present auditor is doubtless not responsible; but in cases where a careful investigation of the current accounts would have disclosed an error in the previous accounts it might well be held that the discovery ought to have been made and that failure to make it was the result of negligence. It is not thought necessary to pursue this subject in detail. It may be pointed out, however, that the mere existence of a ledger account headed "Reserve," with a balance to the credit thereof, should not be taken as conclusive evidence that a corresponding amount of profits available for distribution has been transferred to Reserve; while it would be only prudent to see that proper depreciation had been written off all wasting assets in prior years, as well as in the year under review.

It need, perhaps, hardly be added that it is important that the auditor should see that he begins his investigation at the exact point where the previous investigation left off—that is to say, the opening balances of the period under review should in all cases be checked and agreed with the previous balance sheet. This applies whether or not the accounts for the previous period were checked by the same auditors. Under normal circumstances this checking of the opening balances would probably be done as a matter of course, but the question as to its necessity might sometimes arise where it is the

custom to start an entirely new set of books with each financial year—more especially if the auditing is done at the accountant's office, and not at the client's place of business. By way of showing the extreme importance of adopting this somewhat obvious precaution, it may be added that, some few years since, a case of somewhat extensive fraud, extending over a long period of years, transpired, which might have been discovered at any time, had the auditors checked the starting balances with the previous year's books.

VOUCHERS.

Much might be written, and indeed, has been written, upon the important subject of vouchers; it is, however, impossible to treat the matter exhaustively in the space at disposal.

The present work would, however, be incomplete without some mention of the matter, which, for convenience sake, will be dealt with under the following heads:

(*a*) Receipts.
(*b*) General Payments.
(*c*) Petty Cash.
(*d*) Wages.
(*e*) Bank Account, &c.
(*f*) Journal Entries, &c.

Each of these involves, for its complete consideration, the question as to the form of accounts employed, but the relative merits of the various forms available will mostly be more conveniently dealt with at a later period. In general terms it may be said that the process of "vouching" consists of obtaining *evidence* (usually documentary) that the transactions recorded in the books are *facts*.

(*a*) RECEIPTS.—It is part of the auditor's duty to ascertain, as far as possible, that all cash received has been entered to the debit of the cash book. The usual mode of verification available will be a comparison of the details of the bank de-

posits, but unless the entries which purport to be a copy of the deposit slips are verified at bank they cannot be depended upon, for numerous instances have been disclosed where cashiers have systematically kept the "details of deposits" copy-book, or stubs in agreement with the cash book while the actual deposit tickets contained different items but identical totals.

The reason for this is obvious, *i. e.,* the covering up and "carrying" of collections from customers, the current receipts being used to cover past items not credited. Many of these defaults run on for years in establishments where the cashier has access to the customers' ledgers, and where collections are not looked after sharply by anyone else.

Some years ago an article appeared in *The Journal of Commerce,* written by Mr. D. J. Tompkins, of the Guarantee Company of North America, with reference to customers' accounts, which we reproduce.

"As an officer of one of the older guarantee companies, the writer has had over twenty years' experience of claims under fidelity bonds on defaulting employees. Three-fourths of the defaults by treasurers and cashiers accrue by embezzlement of remittances received, and then by concealing the theft by the 'lapping' system, so-called. For instance, the defaulter embezzles a cash payment by A and defers entry of such payment on cash book until, on receiving remittance from B, he puts B's check into cash-drawer and into bank and then enters A's payment on cash book, but likewise defers entry of B's remittance until the arrival of C's remittance enables him to enter B's payment in similar way. He has to continue this system until the end, or until the shortage is made good. The more items stolen, the greater the number of accounts that must be tampered with to conceal default.

"The result is that as sundry amounts paid in by customers have not yet been entered by cashier on cash book, and hence not posted by bookkeeper to credit of their accounts on ledger, their balances appear on ledger at amounts larger than actually due by them. Manifestly, therefore, no audit can be complete or conclusive as to the existence of a default without the auditor's verification of the ledger balances by communication with agents and customers.

"However, it is not often necessary to thus verify all such accounts to determine with reasonable certainty if such default exists. If de-

fault exists in any appreciable amount its concealment by 'lapping' will involve the existence of irregularities in a considerable number of such accounts; and if there be, say, one hundred accounts on the ledger, let the auditor select ten or fifteen accounts that are fairly representative and verify those. The result will indicate as to the necessity of verifying the remainder.

"Again, there is another means of more certainly determining, right inside the office, whether this lapping system is in vogue to conceal existing default. If, as should be, the employee is required to make and retain on file in the office a carbon duplicate deposit slip showing items deposited in bank each day, the auditor should compare the individual items so shown deposited with the items on cash book for same day. Let him make such comparison for three or four days of each month. If he finds that such individual items correspond, except for explainable differences, he may feel reasonably assured of the absence of any evidence of 'lapping.' But if he finds frequent variances between such items—if, for instance, he finds on certain days such discrepancies as shown by the following, viz.:

Receipts as per Cash Book.		Deposits as per Slip.	
Sept. 5.—Brown	$149.70	Check	$300.00
Smith	205.00	"	275.00
Jones	310.00	"	160.00
Roberts	180.00	"	121.70
Moore	45.00	"	45.00
Thomas	22.50	Currency	10.50
Total	$912.20		$912.20

—in such case the auditor should realize that here exists the indication of 'lapping'—the deposit of checks in different amounts from the receipts entered on cash book—the availing of a deposit of remittances of certain customers to enable the cashier to enter credit to other customers for amounts previously received and entry of which had been deferred—the sure sign of default. True, occasional discrepancies of this kind may be natural and legitimate, but if such discrepancies occur frequently the auditor should know that a thorough verification of all accounts should be at once begun. If a carbon duplicate of the deposit slip be not retained in the office, the auditor should make such comparisons from copies of some of the original slips made by him at bank.

"Since railroad auditors, under pressure from guarantee companies, have begun to test outstandings in the accounts at large freight stations, defaults which formerly ranged from $10,000 and upwards in

such accounts have now dwindled to an average of only $2,000 or $3,000. Only a similar test of ledger accounts will curtail the large amount of defaults now so frequently sustained by insurance, manufacturing and commercial concerns."

After all, the only satisfactory verification of customers' accounts is by direct confirmation, and many auditors now advocate the issue of a circular to the customers, requesting a verification of their accounts as quoted. In many wholesale houses and manufacturing establishments this method is perfectly feasible, but in retail businesses and in some manufacturing concerns the number of accounts involved renders it impracticable to verify all the accounts in this manner. In such cases tests may be made by sending the requests for confirmation to a certain percentage of the customers. The auditor must not communicate with his client's customers on his own responsibility, but must have the authorization of his client for doing so. As a rule it is preferable to conduct the verification in the client's name, provision being made—through the use of a special post-office box or otherwise—for the return of the customers' confirmations direct to the auditor. This method of verifying the accounts receivable is especially desirable in cases of grave irregularity when some special inquiry becomes absolutely necessary in order to ascertain the actual position. It need hardly be added that the mere statement by a customer that he has paid his account cannot always be regarded as conclusive.

Cash sales require very careful scrutiny, and the method of internal check adopted should always be ascertained, and, as far as possible, perfected. Where practicable, it is most desirable that the clerk who writes up the cash book should *not* be the one who receives the money.

Special items of receipt will be more conveniently dealt with when considering the audit of various kinds of accounts.

(*b*) GENERAL PAYMENTS, other than those for wages and petty cash, should (where possible) be invariably made

by cheque, payable to "order." Even where the amount is small this method of payment will, in the vast majority of cases, be simpler, as well as safer, than cash payments. Such payments by cheque hardly require vouching, but it should nevertheless be done, nor will the process be difficult. Receipts can readily be obtained for all ordinary payments, which should be numbered consecutively (the numbers of the cheques are very useful for this purpose sometimes), as should also the items in the cash book.

A receipt on the payee's own printed form is very much better evidence that he has received the amount stated than a receipt on the form of the payer, although, doubtless, a uniform style of voucher will save the auditor's time slightly. From both points of view, it is not desirable that *payers* should provide their own form of receipt; be this as it may, however, the practice exists, and will probably continue to do so.

Where the cheque-voucher is used, the detailed examination of the original purchase invoices can frequently be dispensed with, if not wholly at least to a considerable extent, but in all cases where it is proposed to omit the inspection of the original invoices enough of them should be examined to satisfy the auditor that proper precautions are being taken with respect to cash discounts, freight allowances, short weights, &c., &c.

Some special payments cannot be vouched in the regular way (*e. g.*, the purchase of securities), but satisfactory evidence that the payment was actually made, and value received, should always be obtained.

(*c*) PETTY CASH.—Whatever system of petty cash be adopted, the vouching of petty cash, as a whole, will be the only possible real verification of the payments made from cash to petty cash, and the whole matter may be appropriately considered here. The actual inspection of petty cash vouchers may, or may not, be undertaken by the auditor, as he thinks fit. In the former case, a responsible person must certify the whole of the items *en bloc;* and in the latter case, a similar

person must pass each separate voucher. Important frauds are hardly likely to occur in petty cash; but, as likely as not, petty peculations will arise, if an efficient supervision be not exercised. No auditor can properly supervise the petty cashier, and it is well to acknowledge the fact fully; he may, however, see that every payment has been duly authorized by the responsible head, that the payments made by the cashier have been duly acknowledged, that the footings of the petty cash book are correct, and that the balance unspent is in hand. Beyond this he should not attempt to go.

Some clients have a very bad habit of making comparatively large payments through petty cash. This should be discouraged as far as possible. Some have a still worse habit of allowing the petty cashier to *receive* small amounts; this is a very bad system, and should be most vigorously contested. All receipts should be banked, no matter how trifling in amount, and a clerk in charge of cash receipts should never be in charge of cash payments if it can be avoided.

(*d*) WAGES.—Instances of fraud in the payment of wages are among the most frequent of those that come under the notice of an auditor; but, from the very nature of the case, direct evidence of proper payment is all but impossible. Signatures might be, and frequently are, required from each man receiving wages; but some men can only sign by means of affixing their "mark," while many others would not be above "going shares" with the paying clerk in anything they could get over their due. Circumstantial evidence is thus the best available for the auditor, and this will consist in a good *system* of payment, which renders fraud improbable by reason of the number of persons concerned in the preparation of the pay-sheet and the subsequent payment. Particulars of time worked, or piece-work done, should be certified by the foremen; the calculations of wages worked by one office clerk, and checked by another; the cash for the wages made up by the cashier, and the wages paid by him or his deputy in the presence of a factory manager. Where possible, a cheque

should always be drawn for the exact amount of wages required. The auditor should inquire as to the particular system adopted, and should ascertain that it is really carried out; sometimes it might be well for him to unexpectedly put in an appearance when the wages were being paid. The additions of the pay rolls should be verified, and a week or two's wages taken at random and compared with the original time books or time clock records.

(*e*) BANK ACCOUNT, &c.—All deposits with the bank should be checked off against the pass book. The composition of a few such payments may be advantageously compared with the items which they purport to represent, and any irregularity carefully followed up. The credit side of the cash book should also be checked with the paid cheques, and any disagreement of the *names* should receive careful attention. The bank balance must, of course, be verified, and if the auditor has not himself received the pass book from the bank, he should make a point of either obtaining the bank's certificate showing the balance as of the date of the account, or take it back to the bank, in *person;* otherwise he will run the risk of never having seen the *real* pass book at all. A list of the cheques outstanding should be retained, and it should be ascertained afterwards, either by a second writing-up of the pass book or by inquiry of the bank, whether the amounts agree. If the time of the proposed audit is known, fraud may easily be committed and the cash inflated by drawing a cheque *at the last moment* which will be "outstanding."

The English clearing houses clear the *same day,* which cuts off the kiting of "outstandings" so prevalent in America and encouraged by our "next morning" clearing.

Another fact which deserves mention is that the English system of bank pass books is superior to ours, at least from the auditor's standpoint.

The introduction of adding and listing machines in American banks is responsible for the practical abolition of the old

custom of writing the cheques in detail in the pass book. The consequences of this is that many investigations are greatly hampered by the lack of details, which at one time were always available, but which are now recorded on loose sheets of paper. These lists are almost invariably destroyed, and cannot, as a rule, be found when needed.

Still another "labor saving" custom which has crept in is the mere writing of the word "Balance" in the pass book, neither the footing of the deposits nor the aggregate of the paid cheques being shown.

In view of the numerous defalcations which have arisen through manipulation of bank accounts, including the use of duplicate pass books, it might properly be brought to the attention of the banks that the interests of their patrons are not being properly safeguarded.

The ideal way would be to have each deposit accompanied by a duplicate ticket, to be initialed by the receiving teller and returned to the depositor; to have the cheques written up in detail in the pass books and properly identified by their numbers or by dates.

This suggestion, of course, will not appeal to bankers, who are constantly trying to reduce rather than to increase expenses, but it would, nevertheless, be a great protection to their customers. Such a system is in general use in England, and judging by the dividend rates of most American banks its adoption here would not increase expenses to such a point as would materially affect profits.

In a continuous audit, the vouching should always be kept as close up to date as possible, while the bank and (*all*) cash balances should be verified at every visit. A cash balance will sometimes be found to consist largely of "I O U's"; this should always be discouraged as far as possible. In any event, the "I O U's" should be initialed by someone in authority.

(*f*) JOURNAL ENTRIES, &c.—The modern journal being the book of first entry in which comparatively unusual

transactions are recorded, it becomes just as important that the journal entries should be fully vouched as it is that those relating to cash receipts and payments should be subjected to the same scrutiny. If the correctness of all entries passed through the journal be taken for granted, there is absolutely no limit to the amount of falsification that might be committed with impunity. Improper journal entries might be made with one of two objects—namely, (1) to conceal defalcations, as, for instance, when customers are improperly credited with the amount embezzled, and a corresponding debit made to Allowance or Bad Debts; (2) to fraudulently exaggerate the profits of the undertaking—*e. g.*, by crediting nominal accounts and debiting real accounts with payments that cannot properly be capitalized. It is impossible to deal in detail with the vouching of journal entries, on account of the unlimited nature of the transactions that might be recorded in this book; it may be stated, however, that only the evidence of some disinterested party—or that being unobtainable, the evidence of some person absolutely above suspicion—should be accepted as a voucher, and in the case of all important entries the auditor should take steps which will enable him to form a definite opinion of his own with regard to the matter.

A practical consideration in connection with vouching is with regard to the actual marks an auditor should make to indicate that this work has been performed. In the first place, the voucher should be so marked that it cannot be afterwards used as a voucher in support of another entry; and, in the second place, the entry that has been vouched should be so marked that the auditor can afterwards readily ascertain what items remain unvouched. With regard to the marking of the vouchers, the following methods are in use:—

(1) A large "tick" across the face of the voucher.
(2) The audit clerk's initials, or the letter "E."
(3) A rubber stamp bearing the name of the firm—either with or without the clerk's initials.
(4) The auditor's initial cut out by using a conductor's punch.

As the main object is to so disfigure the voucher that it cannot be again used in support of another entry, it is not very material which of these be employed. It may be remarked, however, that initials necessarily take longer to make than a tick or an impression from a rubber stamp. The third method is, it is thought, generally to be preferred, as indicating clearly who is responsible for the cancellation. In other cases the record in the audit note-book ought to be sufficient for this particular purpose. An additional reason for preferring the third method is that it is the neatest, and as vouchers still continue to form a part of the client's business records after examinations thereof—as well as the possibility of their being produced in court as evidence in litigation—the desirability of using the neatest method is obvious. With regard to the marking of the entries in the books as being vouched, some firms employ a distinct "V," which has the advantage of being clearly distinguished among various classes of ticks, and so enabling a list of missing vouchers to be more readily compiled. Sometimes, however, an imperfect voucher is accepted, and in such case it seems desirable that a special form of mark should be employed, so as to guard against the real voucher being produced in support of another entry.

Where the auditor suspects irregularities that he is unable actually to detect, he may frequently gain his point by *feigning laxity* in his method of vouching; this will often serve to induce that carelessness on the part of the defaulter that is necessary for his detection and exposure. The author, who has had a considerable experience of frauds of all kinds, has found this method work out admirably; it is, however, necessary that it be practiced with discretion, if one wishes to avoid the charge of being actually lax.

BILLS OF EXCHANGE.

A few words on the subject of bills, or as they are usually called "notes," will not be out of place.

NOTES PAYABLE will present but little difficulty; the returned note forms, of course, the voucher for the payment of notes matured, while the notes running (as shown by the notes payable book) will explain the balance of the notes payable account in the ledger.

Notes payable are frequently written on special forms with stubs attached, in which case it is important to see that all are accounted for. It is not likely that they will be numbered by the stationer, as a business man usually does not care to publish generally the number of notes he issues.

Cases have been known where notes payable for large sums have been negotiated without any entry therefor in the books, and special care should be taken to cover this point. Of course, where no grounds for suspicion have arisen during the audit, it may not be thought advisable to make any special examination along this line; but if any doubts have presented themselves it is well to make inquiry at all of the banks with which the client is connected as to the aggregate of loans obtained therefrom, and to make such further inquiries as may be feasible.

NOTES RECEIVABLE require more careful consideration. The notes receivable book should be dealt with *seriatim;* all notes matured or discounted should be traced into the cash book, and, if protested, back to the debit of the customer. All notes protested, or still running and undiscounted, should be in hand, and this fact must be verified.

Discount deducted from notes discounted should be looked into to a certain extent, although not necessarily exhaustively; also, the important question of the liability upon notes under discount, and the value of notes protested, must not be lost sight of. Both these points require to be considered when the provision for bad and doubtful debts is dealt with.

Protested notes should never be allowed to remain in the notes receivable account of the ledger, but should be imme-

diately charged back to the debtor in the event of their non-payment when due.

CONSIGNMENTS.

It is very desirable that all points connected with consignments be thoroughly verified, and for this purpose letter-files, copy letter-books, and accounts current should be freely consulted. There is, however, nothing particular in the nature of the transactions (save the question of foreign currency, which is dealt with elsewhere) that calls for special comment here.

THE TRIAL BALANCE.

It should be the auditor's aim, so far as possible, to carry each department of his investigation right up to the trial balance at the same sitting. Of course, in a large audit, this can very rarely be accomplished; but the auditor must always remember that there is material danger in leaving any portion unfinished in the hands of bookkeepers or cashiers, who—for all he can know to the contrary—may manipulate the figures during the course of the audit.

The auditor, therefore, should endeavor to fix everything up as he goes along, and where he cannot finish the same day, he will do well to keep possession of the books and documents until he can. In fact, he should, so far as possible, keep everything in his own hands until the audit is completed as far as the trial balance. Having once secured a trial balance that he knows has not been tampered with, the auditor may cease to trouble himself about the materials from which it was built up—they may be manipulated and altered up and down, but he holds in his own hand the key of the whole position. Nor need the course indicated cause offense, or even excite suspicion, if carried out with tact. It is generally an easy matter to hang on to a list of balances, and even where it is not practicable to retain uninterrupted possession of a book until it is finished, a few notes and private marks will often serve

the purpose. It is not a difficult matter to acquire a "tick," which, while looking much the same as any other, can be instantly distinguished from a forgery. A man forging ticks will be much less careful as to their form than a man forging initials, and can thus be more often detected. It is not a bad plan to carry about one's own colored ink, and to take care that it is a different make from that in general use at the offices where the audit is conducted. The auditor, however, must be careful not to talk about these things; and he should also be careful not to leave his ink about. It is often a great advantage to employ ink of a different color to that used at the preceding audit.

BALANCING.

In the foregoing paragraph it has been assumed that an exact balance has been arrived at by the bookkeepers before the auditor commences his investigation. This, of course, is as it should be, for clearly it is no part of the auditor's duties (as such) to balance the books. The question arises, however, as to whether an auditor is ever justified in passing accounts that do not exactly balance. Obviously, accounts that do not balance cannot, in the nature of things, be entirely accurate; but so long as the auditor is satisfied that the discrepancy arises from one error, and not from the combined effect of numerous errors, and so long as the difference is so small as to have no practical effect upon the ultimate result, the absence of an accurate balance may sometimes be disregarded. Here, as elsewhere, however, much depends upon circumstances; a nominal or private ledger—or indeed, any ledger with less than, say, 500 accounts—ought certainly to balance exactly; on the other hand, it may be impracticable to insist on an absolute balance with a large individual ledger—hence the importance of these balances being tested at frequent intervals, say, monthly at least.

METHODS OF BALANCING.—In private audits it not infrequently happens that the auditor is requested to balance

the books. The detection of errors in balancing is thus a matter with which an auditor occasionally has to deal, although it does not in any sense form part of the actual audit itself.

There are two modes of seeking for errors in balancing:—

I. By localizing the error.
II. By tabulating the ledger accounts.

LOCALIZING THE ERROR.—This is, of course, best accomplished by framing the system of accounts upon such lines that each separate ledger is "self-balancing." Where this has been done, it is a very simple matter to see in which ledger or ledgers the discrepancy arises, and the field is at once narrowed accordingly. It may easily happen, however, that the various ledgers have not been framed upon self-balancing principles; even then it does not necessarily follow that the error cannot be localized. If the cash book be in tabular form, or if there be separate subsidiary cash books, the equivalent of a controlling account can almost always be constructed; transfers from one ledger to another may complicate matters, but unless such transfers are much more numerous than is usual, they will hardly present any very serious difficulty. On the other hand, it is not often practicable to apply this method if it necessitates an analysis of the cash book.

When the books of original entry have not been in the first instance so formulated as to readily lend themselves to the construction of self-balancing ledgers, one of the many "proof and balance" systems may be used. There are so many of these offered, and their claims so varied, that space will not permit going into details.

An auditor will frequently be asked to point out the best method of preventing errors from remaining undiscovered until after the trial balance is taken off, but so much depends on the person using one of these "systems" that it is usually advisable to recommend to him that he give several of them a practical test and choose the best himself.

TABULATING THE LEDGERS.—This is a method which is sometimes adopted where the number of ledger accounts is not large, and, where practicable, it is extremely thorough. It consists of making an abstract of every ledger account upon sheets, which are virtually tabular ledgers. When the abstract has been completed, the checking of the cross-additions proves the extraction of the ledger balances, while a comparison of the longitudinal totals with the opening balances, day book totals, total of cash received, &c., will show in which direction the error lies. Thus, if the total "Goods Sold" does not agree with the total "Sales Account" in the general ledger, there is clearly an error in the postings or the additions of the sales books. Many accountants, however, and among them the authors, prefer to carefully re-check the ledger, item for item, rather than adopt such a laborious process of localizing the error—especially when it is remembered that even when the abstraction of the ledger has been completed, the localization has been directed, not to one ledger account, but to one subsidiary book.

From the authors' point of view, the chief value of the tabulation of the ledgers is in the event of it being necessary to convert books previously kept upon single entry into double entry: this is a feat which is sometimes necessary when examining the books of an undertaking about to be converted into a corporation, or when endeavoring to frame a deficiency account in cases of insolvency.

AUDIT OF CORPORATIONS.

The chief points arising in the course of the audit of a corporation that do not occur in the audit of a private firm may be divided under the following heads:—

(*a*) The audit of capital stock and bond accounts.
(*b*) The audit of dividend and interest accounts.
(*c*) Compliance with the various statutory requirements.

(*a*) THE AUDIT OF CAPITAL STOCK AND BOND ACCOUNTS.—The main points are: (1) Does the stated amount of issued capital represent a valid allotment to *bona fide* applicants? To ascertain this, the auditor must see that the amount is within the authorized issue, that the various classes of shares (if there be classes) are in accordance with the certificate of incorporation, that the minutes of allotment are in order, that the allottees have agreed to become shareholders to an extent not less than the amount of their respective allotments, that the aggregate number of shares actually issued to the various allottees is equal to the total number stated to have been issued, and that the required deposit has been paid. (2) Has the amount stated to have been paid up been actually received in cash, or else for property under a valid contract?

PREMIUMS received on the issue of shares should preferably be credited to a special Premiums Account, or Capital Surplus, and it is thought better that they should thus be shown as a separate item upon all succeeding balance sheets. There is, however, no law to forbid such premiums being credited to Reserve, or even to Profit and Loss Account.

Where a commission is paid on the underwriting or placing of shares, it is usual to anticipate this by first issuing the stock at par to a syndicate, because in most of the States stock cannot be validly issued at less than par. In some instances, however, where the company's stock sells at a premium, stock is sold above par, and a commission is paid to an underwriting syndicate.

In this case the commission should be charged against the premium, and the net surplus carried to special Premiums or Capital Surplus Account.

At subsequent audits it should be ascertained that the capital stock ledgers balance; the author never heard it contended that a full examination of the stock ledger was part of an ordinary audit.

Bonds, however, are not subject to the same restrictions as stock, and can be issued at a discount. Where bonds were issued for construction purposes it was, until comparatively recently, usual (particularly among railroads and public service corporations) to capitalize the entire discount on the theory that it really represented actual additional cost of property for which the proceeds of the bond sale were used. In fact, prior to July 1, 1907, when the Interstate Commerce Commission's revised classification of accounts went into effect this practice had the sanction of that Commission.

It is, however, becoming recognized that discount on bonds is after all only an adjustment of the interest rate—whether due to insufficient security of principal or to a nominal rate of interest lower than the ruling market rate is immaterial—and that such discount should be charged off to Revenue. If a corporation has advisedly issued a four per cent. bond on a six per cent. basis, why should the Revenue Account not show this state of affairs? Certainly, if the par of the company's credit were six per cent. and the bonds bore six per cent. and were issued at par, no one would question the propriety of charging the entire six per cent. against Revenue annually.

The scientific method of dealing with the discount (termed amortization) is to write it off in instalments during the life of the bonds, so that the aggregate of the discount and the nominal interest charged to Revenue Account is the actual amount of interest paid on the proceeds of the bonds. Where, however, an extremely conservative management chooses to write off the discount over a much shorter period than the life of the bonds, or even in one year, no valid objection could well be raised. In this connection it may be of interest to note that the Public Service Commission of the State of New York (Second District), in the uniform systems of accounts recently prescribed for the various classes of public service corporations under its jurisdiction, expressly forbids the charging of discount on bonds to any account representing the cost of property, and directs the discount to be amortized or, if desired, written off in a shorter period than the life of the bonds.

In view of recent decisions of the courts, it is a grave question as to whether they would uphold the custom of capitalizing the discount, and if the question at issue happened to be the liability of directors for the payment of dividends out of capital, the chances would probably be very much against the directors.

When bonds are sold above par the premium should be credited to a Reserve or Suspense Account and distributed to the credit of Revenue over the life of the bonds. This course, which is the converse of amortizing the discount on bonds, results in the Profit and Loss Account being debited with the interest actually paid on the bonds, *i. e.*, the difference between the nominal interest and the premium received.

It might also be permissible to use the entire amount of the premium in reducing the book value of intangible assets or absorbing depreciation of fixed assets caused by decreases in values not resulting from the ordinary operations of the business. Objection, however, should be raised to treating the entire premium as a current earning of the year in which received.

The trustee of the bonds and the registrar of the capital stock (if registered) should be communicated with and their certificates of the amounts of bonds and stock outstanding compared with the corresponding accounts on the books of the corporation.

(*b*) THE AUDIT OF PAYMENTS FOR DIVIDEND AND INTEREST is not usually a difficult matter. A list of stockholders should be handed to the auditor, showing the number of shares held by each stockholder on the day the dividend was declared, and the amount of dividend due. The footings of this list should be checked, and the totals agreed with the amounts of shares issued and dividends payable respectively; it must also be seen that the rate of dividend is correctly calculated *in toto*. A few of the larger amounts, taken at random, may be advantageously compared with the stock ledger, and the calculations checked; but it is not

generally essential that the whole list be exhaustively verified. Many large concerns draw one cheque for the whole amount of the dividend, and pay it into a separate banking account, against which the dividend cheques are issued. Where this method is adopted, it is a comparatively simple matter to vouch the payments and verify the amount of outstanding dividends—which latter will, of course, agree with the balance of the pass book. Where dividends are paid in cash, or by cheque upon the ordinary banking account, the vouching becomes merged in the vouching of the general payments. The outstanding dividends will not be so easily traced, but will present no special difficulty that requires particular mention here.

It is also usual to draw one cheque for the whole amount of each coupon on a bond issue, and the unpaid coupons will be represented by the balance of the pass book. The paid coupons should be cancelled and pasted in a book, and submitted for inspection. Non-compliance with these precautions might easily result in part of the coupons being paid a second time, and the failure to preserve them may ultimately result in the trustee declining to satisfy the mortgage of record.

The old-fashioned manila leaved invoice book can be used advantageously in filing coupons by using one page for each bond; by taking care that the pages of the book correspond with the bond numbers, almost instant reference may be had to missing coupons.

In the case of all companies most of the following statistical books are practically indispensable, whether required by statute or not:—

Subscriptions and allotments book.
Stockholders' and registered bondholders' address books.
Call books.
Stock ledger.
Bond ledger.
Transfer book.

Strictly speaking there is nothing to audit in these various books—because they are statistical books merely, and not books of account—but the auditor should satisfy himself that the records are kept in the prescribed form, and, *prima facie,* correctly. In addition, he will do well to ascertain that all mortgages that require recording have been properly attended to.

(*c*) COMPLIANCE WITH THE CHARTER AND BY-LAWS, BOARD MINUTES, &c.—Under this heading it is difficult to profitably draw attention to any specific points. It may be mentioned, however, that it is not merely expedient, but also absolutely necessary, that the auditor should carefully peruse such of these documents as may relate to any particular audit, with a view to modifying his course of action accordingly. The special points to which it will be necessary for him to direct attention are, so far as the capital is concerned, as to whether it has been duly authorized; so far as the accounts are concerned, that any special points raised in these documents are borne in mind when considering the method upon which the accounts have been framed; and, so far as the question of profits available for dividend is concerned, as to whether all stipulations as to certain profits being carried to reserve, or applied to the future redemption of bonds by the creation of sinking funds, &c., have been properly dealt with.

It is most important that the minute books of the board of directors, committees, &c., be submitted to the auditor in all cases.

This matter is dealt with further on and need not be considered in detail here.

In the case of certain companies it is also desirable that particular attention should be directed to the various contracts connected with the original formation of the company. The prospectus should be very carefully scanned, with a view to seeing that any special provisions laid down therein are also included in the regulations of the company and have been

acted upon. It is naturally difficult, if not actually impossible, to speak exhaustively in this connection; but it may be mentioned that, supposing a prospectus states, as it sometimes does, that the officers will not taken any salaries unless the company has made profits, or until a certain dividend has been paid to stockholders, then, whether or not a similar provision is contained in the company's by-laws, it is necessary that the auditor should see that it has been complied with in the accounts which come before him for certification. On this point, however, nothing more than general hints can be given.

CHAPTER II.

METHODS OF ACCOUNT.

(Suggested in the Course of Audit.)

It is not strictly any part of the auditor's duty to offer suggestions or issue instructions as to the system of accounts to be adopted, but on account of his experience in such matters he is usually asked to do so. This more frequently occurs during a first audit than thereafter, because the majority of business men in deciding on an audit for the first time are influenced largely by a feeling that an independent examination of their accounts will result in improved methods and helpful suggestions. It is a not at all undesirable state of affairs, but care should be taken not to promise too much. It may easily happen that a client, who is given reason to expect that his expenses will be cut down as a result of an auditor's investigations, finds himself with a larger pay-roll and heavier expenses through the introduction of books and methods which are necessary to so record the transactions that savings may be made in other departments; although the ultimate saving may more than offset the increased expenses. The bookkeeping staff may object to the audit, as they still do in so many cases in the United States, and it may be hard for the auditor to have his suggestions properly carried out. The auditor cannot hope to be of any permanent value unless he masters the entire system of accounts and by his very knowledge compels recognition. In this connection the "entire system" does not mean merely the financial books comprising the ledgers and the books from which postings are made thereto, but the statistical and original entry books, such as receiving and shipping books or records, salesmen's orders, stock records, cost

accounts, and various other books and records which, because they usually are not called for by an auditor, receive scant attention from others. The suggestions in the following chapters will, therefore, not be amiss in the present connection; but it will, of course, be understood that the various questions now about to be considered are, for the most part, largely matters of individual opinion. The views stated in the following paragraphs are those of the authors, but supplemented by various views expressed by recognized authorities, and it is by no means suggested that they should all be unquestioningly taken on trust by the readers of this book. Circumstances notoriously alter cases, and in no state of existence is this more true than in the realm of accounts.

The above remarks will serve to explain the *modus operandi*, not only with regard to the forms of accounts suggested here below, but also in the following chapters, where various important questions of principle are considered.

GENERAL SYSTEM OF INTERNAL CHECK.

This is a matter that may very profitably engage the careful attention of the auditor, for not only will a proper system of internal check frequently obviate the necessity of a detailed audit, but it further possesses the important advantage of causing any irregularities to be corrected at once, instead of continuing until the next visit of the auditor, which—even in the case of a continuous audit—is clearly a consideration. It is very probable that the auditor will be asked to make any suggestions that may occur to him for the improvement of the existing system of accounts, or in the case of a new undertaking he may be invited to prepare a system for the use of his clients. In the latter case at least the work is naturally no part of the regular audit, and should command a special fee, but in the former case it would not usually be regarded as an extra unless the alterations suggested and adopted were of a radical nature.

In devising any system of internal check, there are three matters to be specially borne in mind: first, the person in charge of the cash should never be in charge of any ledger, or, at least, of any individual ledger; secondly, each separate ledger should be made self-balancing, or at least should be so arranged that it can be separately balanced, and where this is for any reason not altogether practicable, it is absolutely essential that those ledgers which are not checked in detail should be so arranged that they may be collectively balanced separately from those ledgers that are; thirdly, where the individual ledgers are numerous and are not checked in detail by the auditor, the clerks in charge should be frequently changed about, so that if there is any irregularity it is impossible for it to remain long undetected without implicating the whole staff. With a system of accounts arranged upon these lines, a detailed audit is frequently not necessary in its entirety; but it is always desirable that the auditor should satisfy himself that the system has actually been carried out as originally designed, and sections of the work should be fully checked at unexpected times.

INSTRUCTIONS AS TO GENERAL SYSTEM OF ACCOUNTS.—It is sometimes desirable that the head bookkeeper should be placed in possession of written instructions containing an outline of the system to be followed. These written instructions will naturally vary very considerably according to circumstances, and it is impossible to give here more than the barest outline of what may be required. The following points are, however, important ones, which will generally require to be included:—

(1) All cash received to be paid into bank daily. The cashier to have no control over any of the ledgers.

(2) All payments other than petty cash payments to be made by cheque, whatever the amount.

(3) The petty cash book to be kept upon the imprest system under the supervision of the cashier. The clerk in charge of

the petty cash must on no account be allowed to receive any moneys for sundry cash receipts.

(4) Vouchers to be obtained for every payment.

(5) The cash and bank balances to be verified daily, and the reconciliation recorded in a special balance book.

(6) All ledgers to be rendered self-balancing, and all individual ledgers to be balanced monthly.

(7) An adequate system of stock accounts and cost accounts to be provided.

(8) All invoices for purchases to be passed by the receiving department, by the buyer of the department concerned, and by the accounting department, before being entered in the purchases book or voucher record.

(9) Statements for payments to be passed by some responsible person, preferably one of the partners, or the manager.

(10) The calculations of all sales to be checked in the accounting department before the ledgers are posted.

(11) Each time the sales ledgers are balanced a list of all accounts more than ——— days overdue to be submitted to the head bookkeeper, and by him to one of the principals for further instructions.

(12) A thoroughly efficient system of calculating and paying wages to be introduced, and closely adhered to.

(13) So far as may be possible, the duties of every member of the staff should be varied from time to time.

(14) Every member of the staff should be required to take a vacation at least once a year.

(15) No member of the staff should be allowed to perform what are (for the time being) the duties of another.

(16) The minute books to be fully entered up, and kept indexed to date.

(17) All exceptional transactions to be reported to the board at the next meeting for approval or further instructions.

(18) The various books required by the State laws to be kept written up, and the necessary returns to be made to the proper officers from time to time.

COST ACCOUNTS.

Every system of bookkeeping, worthy of the name, that purports to record the transactions of a manufacturer, will provide some method of ascertaining the cost of the articles produced, while many systems recording transactions of a purely trading nature (*i. e.,* buying and selling *only*) will likewise find a proper system of costing most advantageous. This branch of an auditor's work has received more attention in the last few years than in the previous twenty, and it is believed that in the United States at least a very considerable advance has been made, although those giving the matter serious attention form a small minority.

It is not considered practicable to treat of this subject in a treatise on auditing, but the importance of proper cost accounts can hardly be overestimated, and should be emphasized whenever an opportunity affords.

There does not seem to be any logical reason for the general practitioner to feel that cost accounting is so complicated that be had better keep his hands off, thus opening the way for the so-called cost-specialist.

The results of the latter's work have not always been happy; in numerous instances where an elaborate cost system has been installed, without regard to the commercial or general system of accounts, the results of the business, as actually stated in the latter, are so at variance with the results produced by the cost books as to give rise to well deserved criticism.

A sane system of cost accounts necessarily works harmoniously with and directly into the commercial books, and the

proper person to bring about this result is the auditor, whose experience is general, rather than one whose vision is limited.

The most absurd development of the recent agitation, however, is the stationery house which manufactures ready-made "systems" in its factory, and "guarantees" the wildest results —such as a daily balance sheet and profit and loss account. All you have to do is to make over your whole business methods to suit their printed forms and they will do the rest (provided, of course, you buy all your stationery from them!)

The auditor should bear in mind that books are intended to record business transactions and the results thereof; therefore it is essential that the system of accounting should be adapted to the needs of the business, and not the business made to fit some cut and dried accounting system.

The literature upon the subject of cost accounting is improving in quantity and quality so rapidly that it is not considered advisable to draw attention to any particular books, but rather to advise the reader to make his investigations as wide as possible.

FORM OF CASH BOOK.

A good form of cash book not only saves time and trouble every day of the year, but also—to an even greater extent—when the ledgers come to be balanced.

It is impossible to go fully into this matter here, but it is suggested that, in all businesses of any magnitude, the auditor should consider the advisability of recommending the introduction of various columns into the cash book that would facilitate the balancing of the various ledgers employed. In an extreme case, the use of a ledger might be almost obviated by the use of a numerous columned cash book; and in many cases a little ingenuity will suffice to materially reduce the labor of posting during the year and to a corresponding extent facilitate the balancing of the ledgers at the end of the fiscal year.

In large concerns a great saving of time may be effected by assigning a separate cash book to each ledger clerk. These separate cash books will, of course, all work into the general cash book. (See further, under "Self-balancing Ledgers," *postea.*)

DISCOUNT AND INTEREST.

A considerable amount of time may be saved by a proper system in recording cash discounts. Every trading or manufacturing concern should have discount columns in its cash book; by which means the necessary number of postings may be considerably reduced. The common practice of posting the total of the debit discount column to the debit of the ledger, and *vice versa,* is, however, condemned by some authorities as unscientific. They claim that an entry should be made at the foot of the debit column for the total amount of discounts received, and posted thence to the credit of the discount account; while on the credit side of the cash book an entry is made in the discount column of the total amount of discounts allowed, which is posted to the debit of the discount account. By this means the total of the debit and credit discount columns will be made to agree, while the advantage of posting totals to the ledger account instead of differences, is not lost. Moreover the rule that the debit cash entries are posted to the credit of the ledger, and *vice versa,* is uniformly maintained, which will always be an advantage theoretically, and—where one is dealing with second-rate bookkeepers—practically as well.

In every case the total of discounts received should be credited to a properly named profit and loss account, and the total of discounts allowed debited. A further consideration arises, however—namely, that, while discounts are theoretically supposed to represent an allowance granted for a payment made before it is due, it is an almost universal custom to deduct discount from all outstanding accounts at balancing time, and to amend the profit and loss account accordingly. The posi-

tion is not very logical; but where, upon the whole, discounts show a loss, there is much to commend it.

Discounts allowed for prompt or anticipated cash payments must not be confounded with trade discounts. Many bookkeepers confuse the two, and it is therefore necessary, in many cases, for the auditor to analyze the Interest and Discount Account in the ledger.

There should, however, be little difficulty in distinguishing between cash and trade discounts; wherever the rate is higher than that which an ordinary concern would usually pay for the convenience of prompt payments it can safely be treated as a trade discount, and the amount so received should be applied in reduction of the cost of the goods purchased.

CASH DISCOUNTS (so-called) received on account of capital expenditure are clearly a reduction of such capital expenditure.

INTEREST, received and allowed, requires to be separated in the profit and loss account, just the same as discount; and, where it is desired to reveal the whole effect of the working of a concern, it is advisable to separate discount from interest.

The question of outstanding discount and interest is dealt with more fully in Chapter VI.

BANK CHARGES.—Before taking leave of the cash book, it is well to note that the auditor might with advantage roughly check the bank charges debited to his client, and see that the rate actually charged is in accordance with arrangements made.

PETTY CASH.

The author is acquainted with two good systems of petty cash, and with numerous bad ones. It is not proposed to deal exhaustively with the latter, but a good system is sufficiently uncommon to merit a record in these columns.

The system of debiting petty cash payments *en bloc* to expenses is bad; and it is therefore assumed that, under each of

the following methods, the various payments are periodically analyzed. The petty cash book should be ruled and balanced at least once a month, and frequently it will be found advantageous to balance at even shorter intervals. The analysis may be made either by means of analysis columns in the book itself or by a summary written in the book after being prepared on loose dissecting sheets, as may be found most convenient.

Under one system the petty cashier is started with an amount, say $100.00, which is supposed to be more than sufficient for the payments for the month (or whatever other period be adopted). At the end of the month he hands the cashier a summary of his payments, and receives a cheque for that amount. On the stub of the cheque the summary (or a reference to it) is written, and the cheque is written up in detail in the cash book at once, and thence posted direct to the debit of the various accounts. Under this system no ledger account is required for petty cash, but an account should in every case be opened for the initial balance, as, if it be left as a floating balance on Office Expenses, or any other nominal account, it is apt to get lost sight of. The chief cashier should thoroughly examine the petty cash book each time he draws a cheque; and when the cheque has been cashed, the initial balance should be shown him intact. The auditor also will, of course, require to see this balance, or to have it properly accounted for.

In some instances where vouchers are required for all petty cash payments, a loose summary sheet is used to which the vouchers are attached and on which they are entered in detail. This system does away entirely with the petty cash book.

The other system is more suitable where the expenditure is too large for it to be deemed desirable to trust the petty cashier with an amount sufficient to cover a month's expenses.

In this case, there will be a small initial balance, and when it becomes nearly exhausted a cheque will be given for the

exact amount spent up to date. This system is thus similar to the former, but with shorter rests; but to avoid numerous entries in the cash book the cheques drawn (including that for the initial balance) are posted to the debit of a Petty Cash Account in the ledger. The result of the monthly summary is credited to Petty Cash Account and debited to the various nominal accounts, either by being posted direct from the summary or by means of a journal entry. The balance of the Petty Cash Account at the end of each month will thus always represent the amount of the initial balance.

It will be noticed that debiting nominal accounts has always been spoken of. In the comparatively rare cases where it is desirable to make purchase ledger and other payments (which involve the debit of a personal account) by cash, every consideration of convenience will tend to the use of a separate cash book for this purpose, which will, of course, be kept upon similar lines to those indicated. Sometimes (as in the case of lawyers) it is better to keep only one petty cash book, but in that case separate columns should be employed for expenses and for payments on account of clients.

Both the above are varieties of the "Imprest System," so called from the demand (or imprest) presented to the chief by the petty cashier from time to time for a sum to reimburse him for his payments.

A good system of petty cash is of the greatest value, both to the auditor and to his clients, and it is therefore always advisable that the auditor should use his influence in this direction.

RENTS (RECEIVED AND PAID).

Where a considerable portion of the income is derived from the receipt of Rents it is probable that some reasonable system of accounts will be found in connection with them; but where the matter is, so to speak, a side-issue, the probabilities are that there will be found to be no system whatever. Cottages

let to workmen are, perhaps, the most ordinary instance of a revenue being incidentally derived from rents received; and, as a rule, the accounts in connection with them will be found extremely primitive. The usual method is to deduct the amount of rent from each man's pay, and credit the total deductions to a Rent Received Account. This method might answer if the proper deductions were invariably made; but under such a system—if a man were allowed to get into arrears, or if no wages were due to him—the matter is very liable to be lost sight of; and, in any case, no proper record will be kept of any allowances made to tenants for taxes, repairs, &c. In every case, therefore, a proper rent-roll should be kept. In general, this will be found an actual saving of time in the end; and, in any case, it will probably save its cost in the increasing resultant revenue.

Suitable rulings for rent-rolls (for rents payable weekly, monthly, &c.) will be found in the author's "Auctioneers' Accounts."

The proportion of rent accrued, but not due, should be included in the balance sheet as an asset; as also should all arrears, unless, indeed, there is reason to believe that they will not be recovered. All accrued and outstanding liabilities for ground rent, rates, taxes, &c., must also be included, and the auditor must not be put off with any suggestion that "they about balance one another." What he has to deal with are the facts.

In the case of cottage property, occupied by workmen, it is desirable to show the whole matter in a nutshell in the profit and loss account; therefore show rents, less expenses, on the credit side, and carry out only the net revenue derived.

Where only a portion of certain premises is occupied, and the remainder sub-let, a similar course should be pursued. That is to say, the total rent paid should be shown on the debit side, the rent receivable deducted, and the net rent paid carried out. It is considered in some quarters that a statement of the

net amount is sufficient; but the effect of the sub-let premises becoming vacant should be considered, for if this be neglected, the amount stated in the accounts would be liable to sudden and unexplained fluctuations. If accounts are intended to show the whole facts of the case, it will be seen at once how defective are statements containing the net amount only.

RENTS PAYABLE.—Where the business is carried on in premises owned by the proprietors and there are other tenants there is no reason why the rent account should not be charged with a fair amount for the use of the premises. This practically amounts to the proprietors giving themselves a lease of the property, which naturally leads to a consideration of the question of leaseholds.

WHERE A VALUABLE LEASE is held, for which a premium has been paid, the annual amount written off for depreciation may appropriately be charged to rent account, it being in fact merely a portion of the rent paid in advance; but it would be well for the accounts to state that this has been done.

"SELF-BALANCING" LEDGERS.

All accountants—and, for that matter, most bookkeepers—will be familiar with the method usually adopted for verifying the accuracy of each ledger in a system of accounts. It would probably be the exception to find a set of books in which some device for the separate balancing of each ledger was not in use; although the system of applying this check is not always properly organized.

When the latter is the case the usual method is to take the total of the list of ledger balances at the previous time of balancing, allow for the total amounts that should have been posted to the debit and credit of the ledger respectively, and the resultant figure should agree with the total of the present list of balances. This method is often of the greatest possible assistance when dealing with books that have been more or less

incompletely kept; but it can hardly be called scientific, and is, at best, but a convenient makeshift.

The general ledger should contain a controlling account for each of the subsidiary ledgers, and in some instances, *e. g.*, ledgers at branch houses or at works offices, it may be found desirable to have a complement of the controlling account in the subsidiary ledger, but in the case of ledgers for accounts receivable, &c., which are kept in the same office as the general or private ledger, it is not, as a rule, necessary to have the controlling account appear in both ledgers. The detailed consideration of this matter is, however, a question of bookkeeping rather than auditing; it will accordingly be found to be fully dealt with in the author's "Bookkeeping for Accountant Students." The controlling account is a most valuable device, as by this means each ledger can, at any time, be balanced with the minimum of trouble, and independently of the other ledgers. Hence it follows that a *rough* balance sheet and profit and loss account can always be prepared in a very short space of time, without involving the labor of balancing every ledger. Again, the clerk keeping the general ledger (naturally the clerk most to be trusted, if not actually one of the principals, or perhaps, even the auditors themselves) has a very good check on every other ledger clerk. *It must, however, never be lost sight of that the only reliable verification of the various balances of the controlling accounts in the general ledger lies in the thorough verification of the various subsidiary ledger balances.* If this fact be lost sight of, there is a serious risk of fraud; but, if the system be intelligently applied, it is a distinct preventive of any kind of irregularity.

The auditor who once adopts this system will find it not only lessens his own work and that of the bookkeeper, but also adds to the completeness of whatever system may have previously been in use; and, further, materially increases the pleasure attendant upon the investigation. Where the auditor himself keeps the private ledger (a not uncommon practice where private persons and firms are concerned) the advantage

of making each ledger "self-balancing" must be sufficiently obvious to need no further demonstration.

Where proper stock accounts are kept, or there is a reliable means of estimating the amount of stock on hand (*cf.* Stock Accounts), the existence of self-balancing ledgers makes it possible for a reliable balance sheet and profit and loss account to be prepared, at any time, in a few hours; and the advantage of this—where no cost accounts can be kept—is hardly to be over-estimated.

TABULAR LEDGERS.—Another form of self-balancing ledger—to which indeed the term "self-balancing" may, perhaps, be more appropriately applied than to the kind described in the preceding paragraph—is the tabular ledger. This ledger is suitable to those concerns in which accounts are rendered only at certain definite intervals, and where the number of customers is extremely numerous, while the number of transactions with each customer is but small. These limitations naturally reduce the general utility of tabular ledgers, but they are common with gas companies, water companies, electric light companies, and also for the purpose of recording the collection of taxes made by various governmental bodies. In each of these cases the account rendered to the customer virtually consists of a single item, but the same form of ledger is sometimes found convenient in cases where a large number of items have to be recorded; in these latter cases, however, a subsidiary ledger has to be kept for the purpose of collecting the items which constitute the account to be collected. Under ordinary circumstances the extra labor involved would go far to prevent the employment of tabulated ledgers in such cases as this, but it sometimes occurs—*e. g.,* in the case of a mine—that the daily deliveries are only invoiced as regards weight and quality, without being priced out, and that the subsidiary ledger is also kept in quantities only; the pricing out being only done when the monthly statement of account is sent in, and this being so, a tabulated form of ledger might conveniently be adopted in such a case, although probably the

number of accounts would not be sufficient to render such a course imperative.

In undertakings with numerous branches or mines it has been found very convenient to use tabular operating ledgers for the various nominal accounts, such as labor, &c.

Instead of having a separate ledger account for the operating accounts (and property accounts, too, for that matter), of each mine, columns are provided for all under the one heading; a total column being used for the general trial balance or balance sheet. This system reduces the number of postings, pagings and labor generally, and makes comparisons and statements easy.

Yet another form of tabular ledger is that in general use at hotels. The especial object of this form is to make the ledger do duty not only as a personal ledger, showing the state of account between the hotel and the various visitors, but also as a nominal ledger, showing the analyzed receipts from day to day. This form of ledger is especially applicable to hotels, on account of the large number of nominal accounts employed to analyze the income derived from various sources; it is also most convenient on account of the fact that it presents the readiest means of keeping each account written up to date, with a minimum of labor.

It is a question, however, as to whether it would not be a saving of time and insure more accurate results to abandon the analyses in the ledger and cash book and depend upon the footings of the original records from which the ledger is posted. The ordinary hotel cashier is extremely careless about the distribution of receipts, and as he usually works "on the jump," there is much to excuse him. It is quite feasible to have the various records from which the postings are made—*e. g.*, restaurant, laundry, service to room, livery, baggage and other charges—either footed in the books themselves or summarized on sheets ruled for the purpose. The cashier by this method need not, of course, analyze his receipts, while at the same time accurate results are obtained.

LOOSE LEAF AND CARD BOOKKEEPING, &c.

Of late years the loose leaf and card systems of bookkeeping have been steadily advancing in favor, and there seems to be every indication that as their advantages become more widely known they will be still further utilized. A full description of the various applications of these systems will be found in the author's "Advanced Accounting," and would be out of place here. It is necessary, however, for the sake of completeness, to now consider the matter from the point of view of the auditor. There can be no doubt but that, unless a thoroughly efficient system of account-keeping prevails, the introduction in any form whatever of the loose leaf system is likely to make confusion worse confounded; but, given a properly organized accounting department, it seems that practically the only drawback that can be suggested is the increased responsibility that is thrown upon the auditor of maintaining a vigilant outlook for fraud.

A great deal has been made by some critics of the possibility of cards, or sheets, being destroyed, and replaced by others containing falsified entries. With a proper system, however, such irregularities would be more speedily detected than would their equivalent under the old-fashioned system of recording all entries in bound books. Bound books are invariably paged or folioed consecutively, but it is safe to assert that no auditor ever conceived it to be part of his duty to make sure that the pages or folios of each ledger were complete. If a folio be neatly extracted from a ledger, it is not unlikely that its absence might remain undetected for months, so long as it had not been removed until after all postings to that folio had been checked.

With both card and loose leaf ledgers it is as a rule better to check the postings by calling back from the ledger into the books of first-entry, as time can generally thus be saved; while this sequence enables the auditor to more readily satisfy himself that the ledger, as presented to him for audit, is complete.

It is needless to say that the loose leaf system is not adapted to every business regardless of any peculiar conditions which may exist. It is true that some stationery houses claim that they can install a system suitable for any business whereby loose leaves and cards can be substituted for every bound book in use, but in numerous instances where this has been done the result has not borne out the expectation, and it simply adds further proof of their inability to displace the professional auditor.

STORES AND STOCK ACCOUNTS.

In many businesses it is quite practicable to keep a reliable record of all goods or stores in stock, and—wherever this is possible—it is clearly desirable that the auditor should place before his clients the indisputable advantages of such a course.

Full details as to the best method to be adopted in all cases would naturally involve a consideration of the particular stocks employed in various trades and manufactures, and would be out of place in this volume, but the following general recommendations (quoted from "The Accountants' Manual," Vol. II) will doubtless prove sufficient for the purpose:—

(1) Debit and credit accounts should be opened, as far as possible, for each description of stores used. On one side of the accounts the receipts would be entered, showing the date, weight, quantity or number, and other particulars; and, on the other side, the stores issued from time to time would be entered, with such particulars as were necessary or suitable, the difference representing what ought to be in hand, or thereabouts—as, in accounts of this kind, the balance shown upon the accounts can hardly be depended upon exactly.

(2) It is the opinion of practical mill-owners and managers that in many cases a really efficient and exact check on stores is not practicable. It could, no doubt, be devised; but the detailed work in connection with it, and consequent labor and expense, put it out of the range of every-day business, what-

ever theorists may say. But many useful rules may be laid down preventive of fraud and waste, amongst others the following, taken from actual experience:—

(*a*) Where stores are distributed for use upon a specific job, the job should be stated, with the weight, quantity, &c.

(*b*) If material of the same kind is distributed to various men for the same purpose, a comparison should be made between the results produced by each. If discrepancies are found, inquiries should be made, and doubtless in some cases a good explanation could be given: *e. g.*, use of old machinery or appliances, &c.

(*c*) The store room should be situated in a convenient place, and be in charge of a competent man who combines practical knowledge of the stores with sufficient bookkeeping experience to appreciate the importance of account keeping.

(*d*) The principal, or manager, should make a point of examining at times the stock ledgers and exercising general supervision of the department. Frequent and unnotified visits should be made, and the storekeeper, *if possible* (it is not always possible), changed (occasionally).

(*e*) Some kinds of stores should never be given out unless the used-up stores are returned. For example, a workman making requisitions for files, brushes, and like things, should only be supplied on his giving up the old articles. This is a very good check, when the nature of the stores will allow of its application.

It will be perceived that the above considerations refer primarily to the stores purchased by factories for their own use; an ordinary amount of intelligence will, however, suffice to render the recommendations there made applicable to a trading concern—that is to say, a concern where the goods purchased are issued (sold) to outside persons. A simple system will be found described in the author's "Advanced Accounting."

In designing stock accounts for trading concerns (and sometimes, also, with factories) it is preferable to arrange for the keeping of the accounts in values as well as in weight or quantity; and, where this can be done, it is clearly desirable —as it is then possible—to make the stock accounts part of the regular system of double-entry bookeeping employed. It is, however, best to retain the record of weights or quantities wherever practicable, as otherwise a discrepancy in quantity might easily be concealed by an error in the values attached to the various stores.

TRADERS' ACCOUNTS.

With some businesses (especially traders dealing in small articles broken from bulk) a regular system of stock accounts is not practicable. In such cases a different method of check must be employed. In every trade there is a well-known percentage of gross profit that ought always to be earned, and can rarely be exceeded. If, therefore, the stock account is started with the actual stock on hand at the commencement of a period, debited from time to time (usually monthly) with the total purchases, and also with the aforementioned estimated gross profits on the sales, and credited with the sales; the balance shown will represent the stock on hand—estimated on the assumption that the nominal gross profit has been exactly earned. The same result would also be accomplished by crediting the stock account with the sales after deducting the gross profit therefrom, rather than debiting the gross profit and crediting the sales. At the periodical stock-taking this estimate can, of course, be easily verified, or corrected. Where an undertaking trades in various kinds of goods, it is always desirable to dissect the sales and purchases, so that the position of the various departments may be readily perceived.

This system is in very general use, and serves two most useful ends. (1) It calls attention to any discrepancy between the actual and nominal gross profits, by means of a similar discrepancy between the ascertained and estimated stock in

hand. (2) It affords most useful information as to the probable amount of stock in each department from month to month, and so serves as a guide to, and a check upon, the various departmental managers, as well as affording material for an interim balance sheet, if one be required.

It is, of course, impossible to give any definite information concerning the gross profits usually made in various retail trades. Naturally, everything depends upon the situation of the store, and the class of business done. Variations are so great in different parts of the United States that it is not deemed wise to attempt the publication of even approximate figures. It is suggested, however, that any auditor would find a table compiled from his own experience of great value.

It is, perhaps, well to note that, in accordance with the invariable custom of traders, percentages of gross profits are based upon the *selling* price of the goods, and not on the cost price.

It may be added that a comparison of the ratio between the stock-in-trade and the sales during corresponding periods is often useful as a rough test of the accuracy of the stock-taking.

Another system is in use in some large department stores where a more accurate check on the various departments is desired. All goods are charged to departments at the selling price, which, of course, has been determined in advance; all changes in values, &c., are recorded, and at stock-taking time the inventory is priced, not only at cost for the private office but also at selling price for the purpose of verification, and the account is supposed to balance exactly. It is surprising to find how small the discrepancies may be in houses transacting a large volume of business.

This system can be extended with advantage to other lines of trade, as, for instance, retail branch stores selling cigars, groceries, men's furnishing goods, &c.

In conclusion, it may be stated that the auditor who has been requested to design stock accounts for any special busi-

ness will do well to avail himself of whatever practical experience may be possessed by his clients, or their managers. Nevertheless, he should take the earliest opportunity of verifying the experience thus utilized by his own; and, where he should be so fortunate as to possess some practical knowledge of the particular business in question—a knowledge he is very likely to have had the opportunity of acquiring—he will doubtless find it of the greatest assistance.

CAPITAL STOCK ACCOUNTS OF COMPANIES.

With regard to these accounts, much that might have been said has been anticipated under the heading of "SELF-BALANCING LEDGERS" (*q. v.*). Each class of shares or stock should have an account opened for it in the general ledger, and such account will, in fact, become the controlling account for that particular stock ledger. By this means all transfers are kept out of the general ledger, and—after the issue has once been completed—no further entries are necessary. Should the issue be a large one, however, it is often preferable to open separate general ledger accounts for "applications," "allotments," and "calls," respectively.

This system may be greatly assisted by the addition of an extra column to the debit side of the general cash book, the items entered in such column being posted to the stock ledger, and the totals periodically posted to the general ledger in the usual way. If this method be adopted, the duplication of entries is reduced to a minimum, and the auditor's work becomes not only proportionately lighter, but also much more certain. With large companies, whose stockholders are very numerous, it is usual to devote a special cash book to capital receipts, and carry totals only to the general cash book. This system lends itself readily to the method advocated.

For full information upon this subject the reader is referred to the author's "Bookkeeping for Company Secretaries," or "Advanced Accounting."

SUSPENSE ACCOUNTS.

Most of the points comprised under this heading will be found to be fully dealt with at a later stage, under the heads of "Outstanding Assets and Liabilities" and "Contingent Liabilities"; but the following, which refer rather to questions of account than to general matters of principle, may be more appropriately considered here.

Any outstanding amounts due, or supposed to be due, either to or by an undertaking, should never be allowed to stand as balances upon a nominal account. The great convenience of bringing the balance down on the nominal account, as opposed to opening a Suspense or Reserve Account which will naturally have to be closed the following morning, makes this method of bookkeeping—if, indeed, it can be called a method—a great favorite with a certain class of bookkeepers; but the objections that can be raised against such a procedure are quite sufficient to outweigh any advantages which it may be supposed to possess. From a bookkeeper's point of view, doubtless, the balance on the nominal account may be deemed to answer all purposes sufficiently well, but the auditor must take a higher view of matters. In the first place, the balance is very apt to be lost sight of, and consequently no adjustment made, at the close of the next period—particularly where a standing balance of petty cash in hand is left open upon, say, the office expenses account. Secondly, the method is open to abuse on the part of a fraudulent bookkeeper, and—in the absence of the suggestive headings of suspense accounts—the matter might possibly escape the vigilance of the auditor. And, again, it is a distinct advantage to arrange the trial balance so that it may contain, in itself, all the information necessary for closing the books, and preparing the balance sheet and trading and profit and loss accounts, and this can only be conveniently effected by making the necessary adjusting entries, by means of suspense accounts, before the trial balance is extracted.

THE TREATMENT OF BAD AND DOUBTFUL DEBTS.

An intelligent system of dealing with the difficult question of bad and doubtful debts is of such assistance to all commercial houses that the auditor should lose no opportunity of suggesting that the matter be put upon a scientific basis.

A very good method is the following:—

As soon as a debt becomes at all doubtful, or sufficiently overdue to merit special attention, it is transferred to a doubtful debts ledger, which is ruled as follows: On the left-hand page are spaces for two or three ordinary ledger accounts, while the right-hand page is left blank for such memoranda as "When applied for," "When sued," "When failed," and full particulars as to progress of subsequent realization of the estate. When an account becomes hopelessly bad (either by reason of the statute of limitations intervening, or an execution remaining unsatisfied, or a final dividend having been distributed, or a composition accepted), *and not until then,* the account is written off to bad debts account; but on no account should an amount be written off until it is known to be irretrievably bad, as an amount, once written off, is almost certain never to be recovered. It will be noted that not the least of the advantages afforded by this system is the peculiar prominence it gives to all overdue accounts, thus offering special facilities for their receiving the particular attention they so urgently require. In a large concern, moreover, it is an obvious advantage that overdue accounts should pass into the control of a different ledger clerk.

Where it is the custom to pass all overdue debts on to an attorney or agency for collection, their simultaneous transfer to the doubtful debts ledger provides a convenient record of all matters in their hands.

The necessary provision for loss upon bad and doubtful debts may be made by means of the reserve for bad debts account, which may be credited with the estimated amount of

such loss, while the bad debts (nominal) account is debited in the usual way. The memoranda recorded on the blank pages of the doubtful debts ledger will readily afford all available information upon which a proper valuation of the amount necessary to be written off may be prepared, and the systematic focussing of such information upn the method here described will generally admit of a much more reliable estimate being prepared than would otherwise have ben practicable.

A practice which has been found desirable in some lines of business is to charge to profit and loss each year (and credit to reserve for bad debts) an amount for estimated loss on bad debts equal to a certain percentage of the sales. The argument in this case is that the loss was not really made in the year when it was discovered, but in the year when the sale was effected. An analogous practice is to set up a reserve equivalent to a certain percentage on the uncollected accounts.

It is obvious that the loss eventually to be realized on accounts uncollected at the date of the balance sheet cannot be accurately determined or estimated merely by allowing for a certain amount of loss on overdue accounts and assuming that all accounts not yet due are good; all bad accounts were at one period of their existence in the latter class. The aim in stating the results of a year's business should be to deduct from the apparent profits on the sales any losses, the probability of which may be foreseen by reference to past experience; hence it follows that a reserve should be made for the entire amount of probable loss on uncollected accounts, one of the principal factors being the percentage either to sales or outstandings experienced in the past.

Since the loss which may eventually be sustained on doubtful debts is to a considerable extent a matter of opinion—though not wholly so—the auditor cannot dictate the amount of the reserve which should be set up. If not fully satisfied, however, as to the adequacy thereof, he should call specific attention to the fact in his report.

THE USE OF THE JOURNAL.

There was a time when practically every entry in a set of books went through the journal, either having its inception in that book or being included in the totals of other books which were periodically journalized. Modern practice, however, has demonstrated that separate books for various classes of entries, such as purchases, sales, &c., are desirable for a number of reasons, and that there is no good reason why the entries in these books should be rehashed in the journal, either in detail or total, but rather that postings should be made directly from the books of original entry to the ledgers. Consequently the journal, as quite generally used among progressive business houses, is now restricted to such entries as cannot be made in the books specially designed to receive certain classes of entries.

The journal is useful for recording inventory totals, closing entries, &c., entries being made therein in preference to making transfers between accounts in the ledgers. The latter method is taught in many bookkeeping schools, but it is not to be commended.

WAGES AND SALARIES.

The best method of paying wages has already been detailed in Chapter I., and therefore nothing further need be said upon that subject here.

SALARIES should, in large concerns, be dealt with in a manner as near thereto as practicable. The distinction made by writers between wages and salaries is by no means invariably clear, and therefore some definition seems desirable. By Wages is meant the cost of labor, and also the cost of the immediate supervision of such labor (foremen, &c.), which would probably be paid for at the same time and in the same manner—in a word, cost of artisans' or laborers' work. By Salaries is meant the weekly or other payments to managers, salesmen, clerks, and other more educated workers. Thus,

wages will be always an expense of production; but salaries may be an expense of production, distribution, or administration, although generally one of the two latter. The above definitions are by no means universally accepted, but for present purposes the classification according to method of payment and of audit appears to be the most convenient.

The best method of recording the payment of salaries is by means of a Salary Book, ruled horizontally for the names of employees and vertically with columns for the successive pay periods. The total of each column represents the aggregate amount paid out on a given date, and is the amount for which credit is taken in the cash book. Where salaries are not paid by individual checks, a check should be drawn for the total in preference to paying from petty cash. This form of salary book obviates the necessity for a separate salary ledger as all the data concerning date of employment, rate, increases in salary, &c., can be shown together with the amounts actually paid from week to week or month to month.

Where the salary book is not written up by some one who has authority to approve the rates, provision should be made for securing approval from the proper person. This will usually make it unnecessary to take receipts.

AGENTS' ACCOUNTS.

With books which are not kept by very skilled bookkeepers, the auditor frequently has a considerable amount of additional, and wholly unnecessary, trouble in connection with the accounts between his clients and their agents, or between his clients (the agents) and their principals. It is therefore very desirable that agency accounts should be kept upon some definite and practicable system. The conditions of agency are so various that it is impossible to deal in detail here with every conceivable set of circumstances arising in connection with this subject, but it may be pointed out, in general terms, that where the remuneration of the agent is dependent upon the

amount of sales or purchases effected by him, every consideration of convenience is in favor of a special sales or purchase book being employed for his transactions; or, at all events, a special column being devoted to these transactions in the general sales or purchase book, as the case may be. When, on the other hand, the remuneration of the agent is by way of profits, or a percentage on the profits earned, whether gross or net, the accounts should be so schemed that an "Agency Account" is opened in the general or private ledger, which virtually becomes the trading, or profit and loss account in respect of the transactions with which the agent is concerned.

From many points of view there is much in common between agency accounts and consignment accounts, and therefore the considerations obtaining under the latter heading will frequently be found of use in connection with the accounts between agents and principals, and may be usefully consulted before formulating any definite scheme upon which these latter accounts should be kept.

CONSIGNMENT ACCOUNTS.

It has already been pointed out under the previous heading that the most convenient method of dealing with many agency accounts is to so arrange the books that what is virtually a special trading, or a special profit and loss, account should be kept in respect of these particular items. These remarks apply *a fortiori* to consignment accounts. The statement will be found in many text books on bookkeeping (chiefly, however, of the unpractical order) that when a consignee receives goods from a consignor it is unnecessary that any entry should be made in his books in respect thereof. This, it will be obvious, is a complete departure from the fundamental rule of bookkeeping, which requires that it should be "a record of transactions," and this proposition seems so self-evident that no time will be wasted in more fully discussing it. Apart, however, from this academical objection, it may be pointed out that every consideration of convenience requires that in the

books of the consignee there should be two accounts for the purpose of recording his transactions with the consignor; the one virtually a trading account, showing the actual result of the trading in the goods consigned, and the other a personal account, showing the position between the consignee and the consignor.

In some cases where several consignments are received from the same consignor, it may be found desirable to open a separate trading account for each, but one personal account will usually suffice.

The same remarks apply to the books of the consignor himself, except that—as he is dependent entirely upon the consignee for the record of transactions after the goods have once left his office—it becomes possible in some cases to adequately record these transactions in one account. In the vast majority of cases, however, it will be found that two accounts are not only more convenient, but in the long run involve less trouble and time in the keeping.

A fuller and more detailed exposition of the best method of dealing with these accounts will be found in the author's "Bookkeeping for Accountant Students," to which the reader is referred.

THE ACCOUNTS OF BRANCH ESTABLISHMENTS

This is a point upon which the auditor will frequently experience considerable difficulty, by reason of the defective system of record employed, and it is therefore of especial importance in connection with the subject of auditing that a really practical system of bookkeeping should be dealt with in this connection.

It may be stated at the outset that the accounts of branch establishments may be ranged under two wholly different categories. In the first case the accounts of the branch are kept at the branch itself, and are practically independent of those kept at the head office; in the second case a minimum possible

amount of accountancy is employed at the branch, returns being made to the head office, and the transactions of the branch incorporated in the head office books. The latter class of accounts, of course, present no serious difficulty, and, indeed, for all practical purposes the bookkeeping is the same as though the branch establishment did not exist, except that for statistical purposes it may be thought desirable that some of the nominal accounts should be divided up so as to show the transactions of the branch separately for purposes of comparison.

It is however, with regard to the former class that most difficulties are likely to arise. In this connection it may be pointed out that any difficulty or complication which can be conceived may be at once got over if the system of accounts at the branch office be regarded in precisely the same light as though the ledgers recording these transactions were in point of fact kept at the head office in self-balancing ledgers, in respect of which controlling accounts were to be found in the head office ledgers themselves. These controlling accounts in the head office ledgers, which, of course, will be written up from returns made by the branches, will provide the means of controlling the record of transactions in the branch ledgers, and at the same time combine the whole system of accounts into one entity. On the other hand, there should be complementary accounts in the branch office books, so that these themselves may be made self-balancing.

When balancing time comes it is necessary that a trial balance should be taken of the branch books, and sent to the head office, and this will be found to explain and verify the controlling account in the head office books dealing with the branch transactions. The trial balance at the head office can then be amplified so as to give effect to these records.

In many cases it will be found preferable not to employ any banking account at the branch at all, but to receive and pay all accounts through the head office alone; and, where the nature of the business renders this possible, every consideration of expediency will be in favor of its being carried out.

Another point which is well worth bearing in mind, where it can be practically applied, is that with certain classes of business—that is to say, those which deal with the sale of goods in bulk without the bulk being broken, it is of inestimable advantage for the purchases to be all made at the head office, and the goods supplied to the branch offices being supplied to them by the head office at selling price. The stock account at the branch office then becomes much simplified, and the balance of such stock accounts should represent the stock actually available on hand, and without any adjustments being necessary in respect of estimated or actual gross profit. It is not necessary that this system should at all confuse the question of the profits actually earned by the branch, because there is not the least difficulty in the goods supplied to the branch being credited to a special account in the head office books, instead of being credited to the general sales account.

The mere fact that a business has numerous branches, instead of merely one, in no way alters the fundamental principles on which the accounts of these branches should be kept; but it need hardly be added that it strengthens the argument in favor of these branch accounts being organized and rigidly kept upon a thoroughly sound basis of internal check, and one which renders itself readily available to the scrutiny and supervision of the auditor.

The introduction of mechanical bookkeeping devices has materially affected the accounting methods of branch offices. It is now possible to duplicate practically all branch records in convenient form for transmittal to the head office, there to be filed in binders provided for the purpose, and thus furnishing the means whereby instant reference can be had to branch transactions. The audit thereof can usually be conducted at the head office with most satisfactory results.

Through the use of typewriters adapted for the purpose, and by one operation, customers' ledgers are posted, customers' monthly statements are written and duplicate ledger sheets

are prepared for the head office, in addition to which the machine automatically registers and adds the amounts posted, which admits of a daily arithmetical proof of all postings.

CAPITAL AND REVENUE.

The distinction between capital expenditure and revenue expenditure is one of primary importance, as bearing upon the fundamental question of what profits have actually been made by an undertaking during any given period. But it is thought that much unnecessary complication has been introduced in discussing this subject, and that, when these wholly irrelevant matters are brushed aside, the fundamental question will be found to be simplicity itself.

Briefly stated, the question can in any event be answered by finding the answer to the following question: "Has the particular expenditure incurred in any individual case been incurred for the sake of improving the earning capacity of the undertaking?" If the answer to this question is in the affirmative then, and to that extent, the expenditure in question is capital expenditure. But if it has only had the effect of putting the earning capacity of the undertaking upon the same footing as that which had previously otbained (and which has since declined by the ordinary process of wear and tear, or the effluxion of time, in respect of which no provision has been made), it must be charged against revenue. The precise meaning of this latter qualification is that the mere *renewal* of wasting assets, not otherwise provided for, cannot be called capital expenditure, but that any extension, or the acquiring of fresh assets, is in the nature of capital expenditure.

PARTNERSHIP AGREEMENTS.

There is an increasing tendency upon the part of commercial men entering into partnership to consult professional accountants as to the provisions which should be made in the partnership agreement with regard to the accounts. This tendency

is distinctly one to be encouraged, as having in the long run the effect of not only consulting the immediate interests of the partners with regard to the keeping of proper accounts, and the equitable apportionment of profits, but also as tending distinctly to lessen the probability of disputes in the future arising out of questions of account.

The subject is, therefore, one which may be very profitably undertaken by professional accountants, and that without in the least usurping the functions of lawyers. This being so, it has been thought desirable to append a few notes as to the points most ordinarily arising in partnership agreements, together with suggestions as to how they should be dealt with.

These are as follows:—

(1) The respective shares of partners in profits and losses should be clearly stated; and where it is provided that these shall be varied during the continuance of the partnership, it is especially important that anything which might tend to effect the amount of agreed profits as between the partners should be very clearly defined.

(2) It should be borne in mind that, in the absence of express provision to that effect, partners are not entitled to interest upon capital. If, therefore, they are to receive interest, the fact should be clearly stated.

(3) The rate of interest on *loans* by partners to the firm should be expressly stated.

(4) Not only should the amount of capital to be introduced by each partner at the outset be expressly defined, but provision should be made as to the manner in which undrawn profits are to be dealt with. That is to say, whether they are to be treated as capital or as loans, the distinction being especially important where it is provided that capital does not bear interest but that loans do.

(5) The amount to be drawn by each partner from time to time on account of profits should be clearly stated, together with the penalty in the event of such limit being exceeded.

(6) If it desired that interest should be debited to partners in respect of drawings, the fact should be clearly stated.

(7) The circumstances under which a partnership may be dissolved should be clearly provided. Too much attention cannot be given to this point.

(8) The exact position of each partner, in the event of a dissolution, is also a matter of the very greatest importance.

(9) In the event of a partner retiring or dying, the agreement should distinctly provide the amount payable to him (or to his representative, as the case may be), and the method by which it is to be ascertained, also the time in which it must be paid, and the interest (if any) it is to bear in the meantime. It is important that the business should not be crippled by making this period unduly short.

(10) In connection with the preceding it is frequently convenient that some special arrangement should be made to obviate the necessity of the books being balanced and stock taken at an irregular period.

(11) The exact scope of the firm's business should be clearly defined, with a view to avoiding disputes as to whether certain profits earned by the individual partners come under the partnership agreement or not.

(12) The extent (if any) to which partners are entitled to engage in other operations, outside the partnership business, should be defined.

(13) It should not only be provided that "proper accounts are to be kept," but that these should be kept upon some adequate system of double entry. They should be balanced at stated intervals, and audited by a professional accountant, and provision made that after the audited accounts have been

signed by the partners they are binding upon each individual partner, except where some manifest error has been discovered within a reasonable time—say, three months.

(14) In addition to the usual arbitration clause, it is very expedient that there should be one to the effect that all disputes upon questions of account should be referred to the arbitration of a Certified Public Accountant (preferably, if the question of expense is to be considered, the regular auditor of the firm), and it should be further provided that, in the event of disputes upon questions of mixed law and accounts, such disputes should be referred to the arbitration of an accountant and a lawyer, the arbitrators having power to appoint a referee before commencing their reference.

INSTRUCTIONS AS TO PREPARATION FOR AUDIT.

As a fitting conclusion to the present chapter, a brief list of instructions—such as might be prepared by the auditor for the guidance of the bookkeeper, showing the work that should be done before the audit commences—is appended. Such a list is the following:—

(1) All postings should be completed, all additions inked in, all balances extracted, and the trial balance agreed.

(2) Vouchers for all payments should be arranged in order, and made available for the auditor's inspection.

(3) A complete list of all books, with the names of the clerks in charge of each, should be prepared.

(4) If possible, the cash in hand at the date of closing the books should be paid into the bank; but, where this has not been done, the cashier must have his books written up to date, and the vouchers ready.

(5) A complete inventory of the stock—priced, extended, footed, and duly certified—should be ready.

(6) All bonds, notes, deeds, and other securities should be ready for production when called for by the auditor, and a list thereof should be prepared.

(7) A list of all overdue accounts showing the provision (if any) which it is deemed necessary to make against possible loss should be prepared.

(8) A memorandum should be kept of any other matter to which it is thought desirable to call the auditor's attention.

(9) A draft balance sheet and profit and loss account should be prepared.

As has already been pointed out, some of the duties comprised in the foregoing may devolve upon the auditor in the case of a private firm or trader; but in the case of a corporation audit it is particularly desirable that these matters should be completed before the auditor commences his investigation, as it cannot be too strongly impressed upon all concerned that the accounts submitted to the stockholders are *not* the auditor's accounts, but the accounts of the directors.

CHAPTER III.

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS.

In the previous chapters the rules laid down have been of as general a character as possible; but it must not therefore, be supposed that the audit of every concern is to be carried out on precisely the same lines. The opportunities for fraud will vary widely in concerns of a different character, while the chances of unintentional errors of principle and in detail will likewise vary extensively in different classes of concerns.

As has been already intimated, the auditor who wishes to be of the greatest possible service to his client should avail himself of every opportunity to become practically acquainted with the working of the business, as it will only be when he has some real acquaintance with the matter he is discussing that his opinion upon the accounts of any given business will possess any great weight; for if he has no knowledge of the business carried on it is impossible for him to intelligently criticise the system of accounts that records the transactions effected, and if he has no knowledge of the nature of such transactions it is hardly to be expected that he would be in a position to form any reliable opinion as to the risk that exists of the transactions not being correctly recorded in the accounts. These remarks will, perhaps, appear trite to many, but so much has been said about accountants "confining themselves to their own province" that it has become necessary to point out the utter inefficiency of any audit which confines its investigations to an inquiry as to the technical correctness of the bookkeeping.

The object of the following chapters is not to supply the reader with such special knowledge concerning each class of undertaking as it may be desirable for him to possess before presuming to certify as to the correctness of its accounts—such a knowledge cannot be altogether imparted by any book, and is beyond the scope (as it is beyond the compass) of the present volume—but in the following paragraphs the reader will find his attention directed to those points most worthy of his consideration in each of the leading classes of accounts he is likely to be called upon to verify. The special opportunities of fraud, and the points upon which an innocent misstatement of facts is most likely to occur will, so far as possible, claim attention; while it may be added that "The Accountants' Library" provides a series of handbooks dealing with the accounts of most of the leading industries, and is likely to prove useful to the reader—whether practitioner or student.

With these preliminary remarks, the categorical consideration of the subject will be proceeded with.

I. COMMERCIAL ACCOUNTS.

(*a*) WHOLESALE MERCHANTS.—The chief openings for fraud in these accounts are: Theft of stock; misstatement of cash sales; fraudulent payment of bogus purchases; misappropriation of moneys received in payment of accounts—such accounts being either left open or written off as "bad"; petty theft by the raising of fictitious items of discount allowed on receipts, or interest incurred on payments; and similar matters. Of what may be styled "innocent" errors, the most common are errors of principle in the valuation of stock-in-trade; insufficient depreciation on leases and furniture; omission to allow for outstanding discounts and interest; errors of principle in the valuation of foreign currencies; omission of liability on outstanding expenses, and on bills discounted; insufficient provision for bad debts, &c. There are not many trade details with which the auditor will require to be acquainted in these accounts, but he will do well to ascertain

the terms of payment and discount accorded to, and by, his clients, and to make use of this knowledge continuously. Where the terms vary—and they generally *do* vary—they should be written in red ink at the head of each account in the ledger. The auditor should make himself acquainted with the percentage of profit expected by his clients, and should compare it, both with the actual results and the rate generally realized by others in the same trade. Stock accounts *can,* almost invariably, be kept by merchants and warehousemen; but this is, in practice, only occasionally done.

The question of patents or trade-marks sometimes arises in these accounts, but the consideration thereof is more appropriately dealt with in a later chapter.

(*b*) MANUFACTURING TRADERS.—Under this heading are intended to be included those manufacturers who ordinarily keep a stock of ready-made articles, and who do not manufacture exclusively (or principally) "to order." The preceding paragraph (*a*) will also apply to the consideration of their accounts; but a few additional precautions are required in connection with their manufacturing departments.

The item of wages, in particular, is one requiring the utmost care; and the question of depreciation of plant and machinery will also require a full share of attention. A proper system of cost accounting becomes all but essential. It is probable that the auditor will find some such system in operation; but it is at least equally probable that the actual system employed will be found both unscientific and unreliable.

(*c*) RETAILERS.—Retailers who give credit in many respects follow upon the same lines as the wholesale houses in the same trade; but the increased number of transactions renders a detailed audit more difficult. It is generally quite impossible to call back all the postings of the sales ledgers, but the balancing thereof can be checked without difficulty, and must always be done. The list of balances should be compared with the ledger, and the footings verified. Where the business is very volu-

minous, the audit of the sales ledgers is frequently deputed to some of the counting-house staff; but, in any case, the auditor should not lose his grip of this department, and should occasionally check the balances himself. To check, say, one or two ledgers at random each year will have all the moral effect of checking the whole set.

Many retail houses supply goods to their own employees, &c., at reduced rates, and allow credit until the following pay-day. A separate "Employees' Ledger" should always be kept in these cases, and the auditor is usually expected to see that the payment of these accounts is not unduly delayed. At every stock-taking he should be careful to ascertain that no amount stands to the debit of an employee who has left.

The purchase ledger is generally of comparatively manageable proportions; consequently it is rarely impossible, though not as a rule necessary to check it *in toto*. In a continuous audit it is frequently arranged that the auditor shall pass all the purchase ledger statements for payment, and the system has much to recommend it. In addition to seeing that each item on the statements is also in the ledger, the auditor should make the ledger clerk initial—and so guarantee the correctness of—every statement that is submitted by him. The auditor should also compare the discount deducted with the terms of payment stated at the head of each account in the ledger. It need hardly be added that this passing of the purchase ledger statements for payment is not a necessary part of any audit, and—where performed—it should command a special fee.

The vouching of cash received—whether for cash sales or sales ledger accounts—may, under a good system of internal check, safely be left to the care of the staff; but it is the auditor's duty to see that the receipts are duly banked and to verify the bank balance. A large retailer's audit will, almost invariably, be continuous; and it is desirable that the bank balance, and also that of the petty cash, be examined at least once a month.

The examination of petty cash has already occupied attention (*vide* Chapter I.), and it therefore only remains to add that—in addition to vouching for the *bona fides* of all payments—it is essential that some responsible person be made accountable for the correctness of the dissection of the items.

The departmental accounts must not be lost sight of, as they form one of the most important branches of the auditor's duties. An account showing the sales, purchases, and estimated stock should be submitted to the principals each month, and the preparation of this account frequently devolves upon the auditor. At the stock-taking the reconciliation of the estimated figures with the actual stock on hand may also profitably occupy the auditor's attention.

The postings of the private ledger should always be called back, and it is highly desirable that such private ledger should contain, within itself, all the materials for a trial balance.

Bills receivable will but rarely be found in connection with a retailer's business; but bills payable are almost certain to exist, and will require attention.

The vouching of payments for salaries must not escape attention, but it calls for no especial comment here.

In cash businesses the problem is somewhat simplified by the considerable reduction effected in the number of sales ledger accounts. Indeed, these accounts are, of course, naturally abolished *in name;* but in some cases they remain in essence as deposit accounts kept by regular customers who wish to avoid the trouble of remitting with every order. It is an important part of the auditor's duty to see that deposit accounts are never overdrawn without proper authority, and that the interest credited (if any) is at the rate agreed upon.

The system adopted for checking the accuracy of the cash receipts, will, as before, require the auditor's careful consideration; but, in the absence of any special arrangement to the contrary, it is not necessary for him to carry his investigation into the accuracy of such receipts beyond seeing that the

system in use is properly carried out, and that the stated returns are duly banked.

It is very usual for credit notes to be issued against goods returned by customers; and, as these credit notes may be used in payment of subsequent purchases by the customers, or the money therefor obtained upon application to one of the cashiers, the question has to be dealt with by the auditor. It is generally arranged that, at the end of the day, the petty cashier shall redeem all credit notes in the hands of the receiving cashiers, the amounts being charged up through petty cash. The issue of credit notes must, therefore, be carefully guarded against abuse; and it is essential that the system under which the various departments are debited with their respective returns be properly arranged. The credit notes should always be compared with the stubs, and presented to the auditor for cancellation. Failure to properly cancel credit notes has in several instances been responsible for fraud, which has been effected by a dishonest employee securing possession of and recashing them.

(*d*) CONTRACTORS.—Under this heading the accounts of those manufacturers who keep little or no ready-made stock will be dealt with. This class includes builders, engineers, shipbuilders, &c.

In these accounts the cost of—and profit or loss arising from—each contract will require to be separately stated; the contractor, in fact, opening a special trading account for every contract. Cost accounts thus form an especial feature of the contractor's books, and an inquiry into the principles upon which they are based is thus a most profitable occupation for the auditor.

The systems upon which stores are issued, and wages recorded and paid, are also of the greatest importance; and time spent upon such an inquiry is likely to be of considerably greater advantage to the client than any detailed examination of the books.

It is also important to call for the monthly statements from the sub-contractors, who will frequently be found to have large claims for "extras" which do not appear to their credit on the contractor's books. Probably the contractor has billed the owner for these identical items and passed the amount to the credit of the contract. Frequently it will be found that an agreement has been made with the sub-contractor to pay him for the extras only in the event of the contractor being successful in collecting, but the books in the meantime show a credit to the contract which must not be carried to profit and loss, and which, therefore, must be offset by a reserve sufficiently large to cover all such items and also for such further claims as the sub-contractor may have, which may not yet have been passed upon or which have not been allowed for various reasons.

The extent of the auditor's examination into detail will be a matter depending largely upon the nature and magnitude of the undertaking. A detailed audit would not usually be necessary, as the main points could generally be accomplished by an examination of the general ledger; in any case the leading principles will be the really important matter.

The same rules which have already guided the auditor as to the extent of his inquiry into details will serve him here; the larger the undertaking, the more its opportunities of internal check, and consequently the less necessity for the professional auditor to check every detail. Many large undertakings keep their own staff auditor, who is responsible for the technical accuracy of the trial balance.

The valuation of contracts in hand and the calculation of depreciation are both matters of the greatest importance, but they will be more conveniently dealt with at a later stage. (See under those headings in Chapter VI.)

(*e*) BREWERIES.—The audit of a brewery is a matter concerning which some experience upon the part of the auditor

is especially desirable, and it is by no means easy to indicate, in a few words, the salient features of the task before him.

Theft of stock and of collections are, perhaps, the two main risks run by brewers. The former is best guarded against by properly designed stock accounts, and the comparative statistics deducible therefrom, combined with a certain amount of practical knowledge—which latter the auditor will most likely have to take upon trust from the master brewer. The second risk arises from the fact that accounts are frequently collected by the drivers; the matter therefore requires great care, but it presents no exceptional features. The discounts allowed must not be passed without inspection, however, as they can easily be juggled with.

In connection with saloons controlled by the brewery, the auditor should see that all the revenue receivable from this—as well as from every other—class of investment is brought into the accounts subject only to due provision for bad and doubtful debts. In most cases loans will be due from the tenants of these houses, and in connection with these loans provision against loss is a matter of considerable importance, and one requiring the most careful consideration. It should, moreover, be borne in mind that the limit of possible loss in most cases greatly exceeds the amount actually advanced, inasmuch as the brewery will sometimes have guaranteed a loan obtained by the tenant, which forms a first charge upon the property. The aggregate amount of such guarantees should, it is thought, be stated upon the balance sheet as a contingent liability.

Another point of considerable importance is the question of depreciation. In the case of a brewery plant, the actual wear and tear is probably less than in the case of most undertakings, because the plant will not be working every day, and thus—apart from the fact that it is running a comparatively small number of hours per week—the intervals of rest afford facilities for making satisfactory and permanent repairs to a

far greater extent than is practicable with most other undertakings. The result is that a brewery plant can in practice be kept at a very high state of efficiency by careful and reasonable repairs and renewals. On the other hand, some items are especially liable to depreciation by becoming obsolete, and this important fact should not be lost sight of.

(*f*) HOTELS.—The accounts of hotels, whether belonging to companies or to private persons, do not call for any extended comment. The auditor who is accustomed to hotel accounts will be able, by a careful examination of the items comprised in the profit and loss account, to form a fairly reliable opinion as to whether or not any leakage exists. If there appears to be any reason to suspect that things are not as they should be, it might be found desirable to thoroughly examine in detail the charges for a portion, at least, of the period under consideration; but, under ordinary circumstances, it is not usual to carry the investigation *behind* the guests' ledger, except for the purpose of verifying the wine room stock books. Proper stock accounts ought always to be kept of wines, liquors, cigars, &c., and these should be carefully inspected, especially if the profit and loss account does not show an adequate return on this department. Where the bookkeeper is also the cashier, especial care must be exercised to ascertain that all receipts are properly accounted for; and it is also important to see that the petty cash disbursed upon behalf of guests has been duly charged to their accounts and collected. The entries in the purchase, general or private ledgers should always be thoroughly checked; and especial care should be given to the vouching of all payments, including wages.

The question of depreciation—here, as elsewhere—is also a most important one, and must be carefully considered. Such items as bedding and linen, plate, cutlery, china and glass, &c., are frequently re-valued for each balance sheet, instead of being depreciated regularly; but perhaps a better plan is to debit profit and loss account and credit renewals account with

a fixed (ample) provision for renewals, the actual expenditure being debited to renewals account, and any credit balance treated as a reserve. The advantage of this course is that it equalizes profits, so that a period of five years could be averaged; but it is well for the auditor to satisfy himself that the amount written off against revenue is ample for all ordinary contingencies.

RESTAURANTS follow, in many respects, the same lines as hotels. The accounts are, in some ways, simpler; but, on the other hand, they are generally less complete. An experienced auditor may prove himself of considerable value to the proprietor of a restaurant, but he cannot pretend to protect him against fraud on the part of his employees; neither is it always possible for him to detect any fraud that may have been committed. He can, however, prepare—or superintend the preparation of—accounts that will show exactly *how* the net profit has been earned, and these accounts will suffice the experienced client, for he knows just about what result ought to have ensued from a given turnover, and so can judge for himself as to the satisfactoriness of the existing management.

It is important, too, that the auditor examine thoroughly the system of collecting for meals served and make certain that it is the most efficient which is practicable under the circumstances obtaining in each case.

(*g*) CLUB ACCOUNTS.—The accounts of clubs follow very much upon the lines previously indicated with regard to hotels; but there are one or two points with which it seems desirable to deal in a little further detail. In the business of an hotel it is practically impossible for the proprietors to rely upon their customers to in any way assist them in checking their employees, but, in the case of clubs, where the members themselves are the proprietors of the undertaking, the accounts can be, to a certain extent, modified with advantage with a view to devising a system by which the members themselves may assist in preventing fraud upon the part of employees.

Numerous instances have been disclosed where the members' dues have been misappropriated, and this has usually happened where the payments were in currency. It is a good plan, therefore, to print a request on the bills to members to pay same by cheque *to the order of the club.*

It is also advisable to request the members to pay their house accounts in the same way, and as it is becoming the custom of many clubs to require all payments to be made at the office, very little difficulty should be experienced in enforcing the rule of payment by cheque.

In connection with the bar, also, the accounts of clubs present an advantage over those employed by many hotels, viz., that all orders for drinks have (frequently) to be signed by the member, and are thus available as vouchers for verifying the taking of wines and spirits out of stock. It may be added, however, that this is a system which is used by a considerable number of hotels, although many dispense with it on the ground that it is difficult to get their customers to take the necessary trouble. In clubs, where the orders are returned to the members monthly after payment of their accounts, carbon sheets are frequently used and duplicate orders obtained.

Another system is that of ticket books, everything bought by members to be prepaid therefrom. It saves bookkeeping—no personal accounts being necessary—and has much to commend it.

In connection with hotels, restaurants and clubs there are—or ought to be—miscellaneous receipts from various sources, such as the sale of bones, fat, &c., from the kitchen and the like. In some establishments, the receipts from the sales of offal are considered perquisites of the chef, but such a system is bad, as all compensation of employees should pass through the payroll. It is extremely difficult, if not well nigh impossible in some cases, to be certain that all such receipts have been properly accounted for. The entire absence of them should, however, arouse suspicion, and it is well to compare the

amounts received during one period with receipts during previous periods.

(*h*) THEATRE ACCOUNTS, &c.—The most difficult feature in theatrical and similar accounts (from the auditor's point of view) is the large amount of cash—i. e., currency and coin—which is necessarily handled by all persons connected with the financial part of the management. It is to be regretted that managers cannot be induced to make their payments by cheque more generally, although the practice is gradually increasing in this country.

An auditor, must, however, above all things, be practical; and it is, therefore, well to face the situation at once, and do his best with the existing cash system, for he may rest assured that no amount of "representation" upon his part will induce managers to make all their payments by cheque, while it is, of course, quite impossible that their receipts should be, to any great extent, in anything but currency.

It is not usual for the auditor to be expected to verify the cash receipts; this is usually performed by the treasurer, who is considered a sufficiently responsible person for the performance of a function that requires integrity certainly, but no great technical knowledge.

Theatre accounts differ so widely from ordinary commercial accounts that a brief description of their methods is in order before we consider the question of audit. The treasurer makes up a daily statement as follows: About half an hour after the beginning of each performance the treasurer of the theatre counts his unsold coupon tickets and makes up a "rough" statement of the cash which should be on hand; to this he adds the proceeds of sales of "hard" tickets (general admission and exchange) and he then submits this statement to the treasurer of the company. The two treasurers then count the tickets contained in the doortenders' boxes, which, except in stormy weather, agree very closely with the rough

statement. After the count the theatre treasurer makes out a final statement, which is signed by both treasurers.

At the end of each week the theatre treasurer makes up a "settlement sheet," which shows the gross receipts, and the share of same due to the theatre. To this are added any additional earnings, and after deducting the salaries and petty expenses, he pays the remainder, in currency, to the manager. The latter usually pays all advertising, bill posting, light, &c., about Tuesday of each week to cover the previous week. In some theatres the treasurer pays all bills and settles with the manager for the profit or loss shown by the weekly statements only, but this is unusual.

The treasurer of the theatre also prepares a complete weekly statement for the company treasurer, and settles therefor. After making these two settlements he would have on hand only the receipts of the "advance sale"; this is an important item sometimes, and will be considered again further on.

The object of theatre bookkeeping is to show the profit or loss of each week's business so as to determine which attractions pay best. It is, therefore, usual to apportion such items as the annual license fee, rent, repairs, &c., weekly on a basis of a season of thirty or thirty-five weeks.

With the foregoing in mind the audit of theatre accounts will be a simple matter, and should be made somewhat as follows:

Count the coupon tickets in the rack and deduct the number on hand from the total capacity of the house; secure a statement of "hard" tickets furnished treasurer at beginning of season, deduct number on hand at time of balancing, and the remainder must be accounted for in cash. The total result should then agree with the cash and vouchers in the hands of the treasurer.

See that all nightly statements during period covered by audit are signed by the treasurers of the *companies*. Com-

pare contracts with managers' settlements to ascertain that receipts have been properly divided, and that the proper shares of "extras" have been collected from companies.

Call for properly authorized vouchers for all payments. The vouching of payments resolves itself upon the lines ordinarily adopted in trading concerns; and here—as elsewhere—it is not the least important of the auditor's functions to inquire into the manner in which the pay-rolls are prepared. It need hardly be stated that all persons entering the premises before a performance sign an "Attendance Book" kept at the stage door for that purpose, and that fines for absence or lateness are arrived at from this source. It is not usual for the auditor to verify the composition of the pay-rolls, but there would be no harm done if he did so occasionally—and unexpectedly.

It will be easy to suggest improvements in the methods generally found in force, but it will be almost impossible to secure any changes. One of the greatest difficulties in theatre accounting is to divide the responsibility of the treasurer and his assistant. They both have access to the same cash, and, as it takes an expert at least an hour to count a rack, it will be seen that one cannot balance to the other as hotel clerks do when they change watch. The same difficulty arises in connection with the weekly payments to the manager. After making settlement with him the cash remaining represents the advance ticket sales, which, of course, should be verified at the time. Owing to the difficulty of counting a large number of tickets, managers seldom do it, and more than one defalcation has been carried along by means of using the proceeds of advance sales to cover up shortages.

In "continuous performance" houses most of the admissions are "strip" tickets, which are, of course, easily counted.

(*i*) THEATRICAL COMPANIES.—The audit of the accounts of a company should be quite a simple matter, but owing to the conditions under which a company treasurer

usually works, his books and accounts will be in a more or less unsatisfactory state.

In any event, he should be required to keep a cash book and balance it at least once a week.

With this as a basis it will be comparatively simple to build up what are generally known as "Production" accounts, which may be classified as follows:

Preliminary Expenses.—Covers all expenses incurred during rehearsals, such as stage manager's salary, musical director's salary, typewriting parts, orchestra, rent of hall, &c.

Scenery.—This is usually built by one firm, but it may be painted by different artists. A certain high-priced artist may be engaged to paint a difficult landscape, but the painting of a simple interior would be given to a cheaper man. The work of building and painting is nearly always done under contract and payments made at specified times.

Properties.—This item includes almost everything used in the stage representation which could not be classified as scenery, costumes, or electrical apparatus. It includes furniture, draperies, artificial flowers, spears, animals (either papier maché or alive). Perishable properties are not charged to production, but to current expenses.

Costumes.—This item includes hats, wigs, shoes, &c.

Electrical Apparatus.—This covers calcium lamps, special devices, &c., and is sometimes a very large item. Some companies rent the electrical equipment; the rental is then charged to current expenses.

The company's profit and loss account is also made up weekly to accord with the theatre accounts. An audit would consist largely in checking the receipts by comparison with the nightly statements signed by the house treasurer; seeing that all fines imposed by the stage manager have been collected; examining the contracts and securing proper vouchers.

Theatrical productions are so uncertain in their outcome that no rule for dealing with the question of depreciation can be laid down. Obviously the copyright of a successful play is an asset which does not depreciate rapidly in value, while the total cost of an unsuccessful production must be written off at once. It is stated on good authority that the entire cost of production is charged off against the first year's business by all of the New York managers. Each undertaking should, therefore, be considered with respect to the usual custom, provided it is conservative.

(*j*) PUBLISHERS.—The audit of publishers' accounts presents a peculiar combination of complications. In many cases publishers will do their own printing, and in this respect they follow the rules of manufacturing traders. (See under heading I. (*b*) above.) Almost invariably, however, they will also be retailers, and hence the considerations detailed under heading I. (*c*) will also apply. Many houses add the further occupation of trading, either wholesale or retail, or both, in the publications of other firms, which, to a great extent, brings them under the heading I. (*a*) above; while almost every house will occasionally undertake the publication of authors' works upon such terms, as to royalty, &c., as make it absolutely necessary that both stock accounts and cost accounts should be carried to perfection. In this respect publishers' accounts involve many of the considerations discussed under heading I. (*d*) when dealing with Contractors' Accounts.

A complete audit of publishers' accounts is on account of the multiplicity of detail involved a practical impossibility; the extent to which a partial audit may advantageously be carried must, on the other hand, of necessity, vary with almost every individual case. The considerations involved in the previous paragraphs are the only ones that can be offered; but it may be added that here—as in the case of all other partial audits—the precise routine may be varied from time to time with the greatest advantage.

Permanent assets, such as buildings, plant, &c., must, of course, be subjected to proper depreciation, and stock-in-trade will require careful valuing. It ought to be possible for the auditor to obtain absolute proof as to the quantity of stock-in-trade, but he can hardly be expected to check the inventory *in extenso*. The prices set upon unsold publications should never exceed the cost of production.

Care should be taken to ascertain that the stock list is not unduly inflated by almost entire editions of absolutely unsalable publications that are not worth anything like the cost of production.

With regard to the valuation of copyrights for balance sheet purposes, it is usual for a separate account to be opened for each publication, which is, in the first place, debited with the actual cost of production, including, of course, the printing, binding, illustrations, &c. (and, where the copyright is purchased the purchase-price thereof, together with that of any stock which may have been taken over therewith.) Many firms at balancing time review the debits to the various copyright accounts, depreciating some and appreciating others; that is to say, the system is adopted of valuing the copyrights by inventory at each period of balancing, wholly irrespective of the actual cost. It is, of course, very desirable that where necessary the cost should be written down from time to time; but the arguments with regard to the writing up the value of a copyright are precisely those which might be—and, indeed, should be—invariably used against writing up the value of the asset goodwill and crediting the difference to profit and loss account. It may be perfectly true that a large revenue is expected from this asset in the future; but that, in itself, can afford no possible argument for anticipating that revenue, and taking credit for it in the current period. On the other hand, it will probably be generally admitted that no great harm can be done by writing up such copyrights as have appreciated so long as the actual effect of so doing is not to increase the book-value of copyrights as a whole. In this connection, it

may be mentioned that with many houses there is a good general rule in use, to the effect that the value attached to any copyright should not exceed three years' purchase upon the gross profit earned therefrom during the past year.

Sometimes, even when a publication is itself a failure, some residual value will attach to illustrations, &c., which have been used in its production. It is very important, however, that no fictitious estimate should be put upon the value of such doubtful assets as these, and of the two it seems infinitely preferable that they should be stated at *nil* in the balance sheet.

The value of artists' original drawings (for illustrations) is often considerable, and has not infrequently been found to exceed the price originally paid for both original and copyright. It is hardly safe, however, to reckon such originals as assets—if valuable, they will generally be sold, and if retained, the most that can be said is that they have a latent value.

It is unfortunately the custom in many large publishing houses in the United States to carry their plates at cost, or with a very small allowance for depreciation. No matter how successful the publication may be, it should always be borne in mind that every book turned out will have to bear a proportionate share of the costs of all the plates. The failure of more than one publisher has been traced to this omission.

On behalf of his clients it may be thought desirable for the auditor to thoroughly check all royalty accounts, but this does not form part of a regular audit.

Newspapers and magazines present several special features. In the absence of a staff-auditor, the auditor will require to satisfy himself that every advertisement is eventually paid for (unless, of course, a bad debt has been made), or else that it has been franked as "free" by some responsible person. The commission accounts of agents and canvassers should also always be examined.

In the case of a monthly magazine, at least two numbers out of twelve should be selected and checked thoroughly to

see that every advertisement is accounted for. A certain portion of the contracts should also be checked into the advertising register, as it very often happens that this book is kept by a clerk in the advertising department who does not appreciate the importance of accuracy.

The subscriptions will be more difficult to verify. Usually, however, great care is taken to secure a good internal check, and the system should be looked into carefully. It is needless to say that the clerks in charge of the subscription cards and records should not have access to the cash. The balance sheet, must, of course, contain a reserve for unfilled subscriptions, although most publishers do not provide such an account.

The "inside" of a paper is the work of the regular staff, or of "contributors"; the former are usually paid a regular salary, the latter are paid for the actual work done. It would be a desirable thing to make sure that a contributor was never paid for a sub-editor's work, but no auditor could ever ascertain such a thing for himself, and he must therefore rest content with the certified contributors' accounts as they are submitted to him.

It frequently devolves upon the auditor to prepare weekly, or monthly, statements, showing approximately the income and expenditure. Such work naturally commands a special fee.

The printing of the publication calls for no special comment here; when done by the proprietors they will, of course, be printers, as well as publishers, and the auditor must take his stand accordingly.

The number of copies printed, issued, returned, exchanged, distributed free, and in stock, should always be certified by the publishing manager. From his returns the individual ledger debits may be vouched.

The Post Office returns, or vouchers, for second-class postage are a good check on the total circulation of a periodical.

Every periodical is started at a loss, and it is usual to debit this loss to an Establishment Account; when the concern pays —and so acquires a goodwill—the cost of such goodwill is represented by the amount to the debit of Establishment Account, which thus virtually becomes a Goodwill Account. There is no great objection to this system, and it is much in favor on account of the information it afford to the intending purchaser of a recently established paper; but, when a periodical is once fairly started, the auditor should require a very good reason to be furnished him before he sanctions the transfer of an unexpected loss to the Establishment Account; if such loss arises from an increase of matter (in quantity or quality) or a reduction in price, it may be in the nature of capital outlay, as tending to increase the permanent value of the concern, but an unexpected loss is likely to have the contrary effect.

II. MINING ACCOUNTS

(*a*) COAL MINES.—Better advice can hardly be given to the accountant who is about to audit the accounts of a mine for the first time than to suggest that he should make a tour of the whole works (both above and below ground) in company with the colliery manager. If he be of an observant turn of mind he will probably by the end of his inspection, have formed at least some idea of the scope of the undertaking, and he will doubtless find that the gloom of the underworld has thrown considerable light upon the records kept above ground. Even the auditor experienced in colliery accounts will probably find that the thorough inspection of a new mine is really a wise economy of time; in fact, whatever the nature of the business may be, the auditor who acquaints himself with the manner in which it is carried on does wisely.

A question of particular importance in these accounts is the treatment of the capital expenditure account. Great care must be taken to see that no expenditure properly chargeable against revenue is included herein—indeed, it is always de-

sirable to get the capital expenditure account altogether closed as quickly as possible.

Some mining companies, in calculating the cost per ton of the ore extracted, include the expense of dead work, development, exploration, &c., while many others state as the cost of extraction work the actual expenditure for stoping and hoisting only, treating the development work, especially in shaft sinking, as a capital expenditure.

The item "Minimums paid in excess of royalties earned," which frequently occurs as an asset in the accounts of young collieries, requires some little explanation. The royalty payable is based upon the quantity extracted—usually upon the number of tons, but sometimes upon the number of cubic yards, or the acreage of the seams worked—a fixed "minimum" royalty being payable in any event, whether the mines are worked or not. During the sinking of the shafts and first working of the mine, therefore, the royalty paid naturally exceeds the normal percentage upon the output. Under ordinary circumstances this would represent a charge against Revenue in the usual way; but, as the lessees are empowered to recoup themselves out of subsequent production, it is quite justifiable that the excess so paid at first should be carried forward as a set-off against the output of later years. It is very necessary, however, that the auditor should examine the constitution of the amount so carried forward. It not infrequently happens that the mine as a whole is comprised of several leases, some of which are not being worked, and never will be; the minimum royalty upon such portions ought, of course, to be charged against Revenue each year, and where, in the early days of the colliery's existence, an accumulation of such minimums has been allowed to be carried forward, it must be written off as soon as possible. Again, there is often a limit to the time during which advance royalties may be recouped, and this limit, of course, must not be exceeded. It need hardly be added that the only justification for treating the whole—

or any portion—of the balance of this account as an asset is the reasonable probability that it will be redeemed out of future production within the time limit allowed by the lease.

The question of depreciation upon mines is naturally one of no slight importance; but it is not certain that—however desirable it may be that an adequate provision should be made for depreciation arising either from the exhaustion of minerals, or from the lapse of the lease, or from both—it is legally necessary for a mining company to set aside any portion of its earnings to replace wasting capital. The auditor can thus do no more than advise the extreme desirability of so prudent a course.

Many mortgages upon coal and ore lands require a sinking fund to be established to cover exhaustion, usually at a fixed rate per ton. Here, of course, the accounts must be constructed accordingly, and a careful reading of all mortgages will be required.

Unfortunately, sinking fund provisions in mortgages are not always entirely clear. They are almost invariably written by lawyers, who rarely consider the matter in connection with the accounts of the undertaking.

For instance, where a clause in a mortgage on coal lands requires the setting aside of five cents per ton on all coal "shipped," a difference of opinion can easily arise over the question as to whether the coal consumed in the company's own operations both at the mines and in transit should be provided for. If the provision was based on probable exhaustion, certainly every ton produced must be taken into account, but if the original intention was to cover sales, no payment to the sinking fund would be required therefor.

Subsequent differences of this nature would not arise if more attention were given to the wording of these provisions.

In this connection it will be of interest to note the following extract from "The Profits of a Corporation," by A. Lowes

Dickinson, F. C. A., C. P. A. (paper read at the St. Louis Congress of Accountants, 1904):

"In the case of minerals, the product taken out of the land becomes the stock-in-trade of a corporation as soon as it is extracted, and whatever the land was worth before its extraction it is clearly worth an appreciable amount less thereafter. The provision to be made should be on the basis of the number of tons extracted, having regard to the total tonnage available and to the realizable value of the property after the minerals have all been extracted. The same principle would also apply to timber lands, where no provision is made for reforesting. The contention is sometimes made that no provision need be made for exhaustion of minerals where the amount of mineral known to be in a definite tract at the end of any period is largely in excess of that which had been discovered at the beginning of the period. This argument cannot, however, for a moment be admitted except as a reason for reducing the tonnage rate to be provided. As a general principle, whatever there was in the land, whether known or unknown, has been reduced during the period under consideration by whatever amount has been extracted; and while the new discoveries may be accepted as reducing the necessary rate of provision for extinction from (say) one dollar to one cent per ton, the original principle that provision must be made holds good on the smaller figure, whatever it is. It may be, of course, that the provisions made in earlier years have been sufficient to cover a number of future years on the basis, from the commencement, of the rate subsequently found to be sufficient in view of the new discoveries, and in this case there is obviously no necessity to provide further for extinction until the total production at the new rate is equal to the total amount written off."

Usually mining companies own the cottages occupied by their employees, and this matter will require the auditor's attention. Rents receivable, however, have already been considered.

(*b*) GOLD MINES, &c.—The services of an auditor are frequently required in connection with gold, silver, copper, and other mining enterprises carried on in the far West. Usually the services consist in ascertaining for dissatisfied creditors or stockholders just where the cash capital has been sunk, in which case it is rather of the nature of an investigation than an audit. It sometimes happens, however, that ore is actually found in paying quantities, and the question then

arises as to how far the mine manager's accounts can be accepted. He usually remits periodically a statement of his receipts and payments, which is incorporated in the accounts kept at head office. Such accounts are not usually very voluminous, and are generally examined by the auditor *in extenso*. It is, of course, desirable that all expenditure at the works be properly vouched, and for the auditor to examine these vouchers.

For balance sheet purposes the mine manager should be required to apportion all expenditure between capital and revenue, and to certify such apportionment; also to submit a certified statement of local floating assets and liabilities, or a certificate that no such assets or liabilities exist locally, and at the same time he should report upon the state of efficiency of the plant and machinery, together with any buildings and other more or less permanent assets there may be upon the works. This latter report is most essential for a proper consideration of the question of depreciation.

It is always well—and where the produce of the mine is precious, it is very essential—for the auditor to use every available means of ascertaining that credit has been taken in the books for the value of the whole of the output.

Depreciation of plant should, of course, be provided for; but that question is best dealt with in a later chapter.

The wages paid by mining companies require the same careful attention that must at all times be accorded to this most important item; but inasmuch as the great bulk of wages paid is at the rate of so much per ton, the aggregate amount payable can be tested with greater facility than in many other cases.

The peculiar conditions obtaining to mining accounts generally render it desirable that the audit should descend into somewhat considerable detail; concerning the actual extent of such detail, however, no general rules can be given, as

each case must be judged upon its own merits. Great care should be taken to see that no expenses are capitalized that are not *bona fide* of a "capital" nature.

In conclusion, it may be added that the auditor should expressly state in his report what the precise extent of his examination has been.

III. FINANCIAL ACCOUNTS.

(*a*) BANKS.—In dealing with the question of bank audits, it is well to remember that one of the most controversial subjects relative to professional practice is being discussed. So far as possible, a position that few will care to assail will be occupied; but it were well to admit at once that the authors consider the duties of a bank auditor to be very much more onerous than some eminent accountants care to admit, whatever his bare legal responsibilities may be. It is not necessary to criticise the motives that have dictated the position taken by some of the leading members of the profession; but it is difficult to see the force of an argument that virtually amounts to the assertion that the mere multiplicity of a series of statements is a valid reason for not inquiring into the accuracy of those statements. Further, it is to be remembered that the bare legal responsibility is not the highest measure of the duties of a professional man. It is certainly very desirable that the law should not be unduly harsh—or the position of an auditor would be intolerable—but it is imagined that few would consider that they had discharged all moral obligations when they had complied with their legal duties. These remarks, however, apply equally to all classes of audits.

The inference must not be drawn, however, that the authors consider that a bank audit is fundamentally difficult, or that it requires special knowledge of an extraordinary sort; on the contrary, it can be successfully maintained that a general practitioner of wide practice is better qualified to audit the accounts of a bank than one who devotes his entire attention

to this class of work. In the latter case the mere familiarity with the usual books and methods tends to narrow one's vision, and a bank examiner is apt to fall into a rut. After all, the theory of a bank audit is very much like that of any other audit, and the same careful study of a bank's statement which an auditor must pay to the balance sheet of a manufacturing concern will indicate to him the scope of the audit, and after one or two experiences he need expect no trouble.

In all cases the auditor should secure the most recently published statement of the bank whose accounts he expects to examine, and a general scrutiny of the several asset and liability items will reveal far more of what he has before him than in almost any other work he undertakes.

Under our National Banking Act, compulsory examinations are made by examiners in government employ, and while in the past they have rendered valuable service, and many of them are auditors in the highest sense of the word, it must be remembered that their chief duty is to see that a bank is solvent and complying with law, and this accounts for the large number of minor defalcations which they never discover. Owing to the insufficient time which is allotted to each bank, it is a physical impossibility for them to cover the ground thoroughly, and it is no longer a rarity to hear of bank defalcations which have been going on under the eyes of the national bank examiners for twelve to fifteen years.

For these reasons bank directors are gradually coming around to the feeling that it is their duty to have more thorough audits, and naturally the work falls to the Certified Public Accountant, and it is very satisfactory to note that several State bank examiners have made recommendations to this effect.

The certification of a bank balance sheet involves the thorough examination and exhaustive testing of every account in the general ledger, the counting of the balance of cash in hand, the examination of all notes (especial care being taken to note

that all overdue notes are properly explained) and the inspection of all securities—whether owned by the bank or held as collateral for borrowers. With regard to the counting of the cash balance, the only safe way of dealing with cheques in hand is for the auditor to himself forward them to the clearing house and other agents, or where this is impracticable, to secure direct confirmation of the clearing house returns. The disregard of this precaution has left the door open for most serious frauds upon the part of bank managers and others.

The counting of the cash in a large bank is very hard physical work, to say nothing of mental strain. As the securities and collaterals should be taken up the same day, it is useless for an auditor to undertake this work unless he has a staff of reliable men, some of whom should have had previous experience in counting cash and handling securities. Not less than five or six men will be needed the first day in a fairly large bank, but after (say) the second day the force can be decreased.

It hardly seems necessary to urge the importance of making the audit without notice to any one, and this means the officers and directors as well as the tellers and other clerks.

The work of counting the cash and examining the securities can be commenced early in the afternoon by taking up the reserves first, and working down to the settlements. The staff should be so distributed and instructed that any transfers from one teller to the other, or sending out for cash to conceal a defalcation, would be immediately detected.

The examination of demand loans and collaterals therewith is one of the most important branches of the work. Extensive defalcations have been covered up by the failure to endorse partial payments on the notes; the only way to ascertain the correctness of these loans and collaterals is to send out a memorandum to each borrower, setting forth the amount of loans and collaterals held as at the day of commencing the

audit. The confirmation should, of course, be returned direct to the auditor.

The recent death of a prominent broker in Philadelphia disclosed the fact that for some years he had been borrowing large sums, aggregating nearly one million dollars, from banks upon stock certificates which had been "raised" from a small to a much larger number of shares. The forgeries were cleverly executed, and in every case deceived bank officers through whose hands they passed, so that a professional auditor could hardly be criticised for failure to detect the alterations; the instance should, however, be borne in mind, and a knowledge of the facts in this case may be a reminder to an auditor that "eternal vigilance" is always necessary in bank audits.

In connection with the inspection of securities, it is, perhaps, well to call attention to the extreme importance of *all* the securities being produced simultaneously, and of their all remaining in the auditor's sole keeping until the inspection is completed. Extensive frauds have been known to remain undetected through failure to observe this simple precaution. If the examination cannot be completed the first day, the securities and bills not inspected should be locked up, and access denied to any one connected with the bank except under the eye of the auditor.

The accounts with other banks will have to be verified by correspondence, and these confirmations should also be directed to the auditor and not to the bank.

How far the auditor should extend his examination of the depositors' accounts is a matter concerning which considerable difference of opinion obtains. The ideal way would be to have all the pass-books called in at once, and have them settled by the auditor's own staff. It is, of course, practically impossible to do this, but it is of the utmost importance that as many be examined as possible. The auditor should keep a list of the books inspected, and in the course of a few years the entire list of customers might be covered.

The auditor should see that a proper internal system of checking the balances prevails. It is now customary in large banks for all pass-book balances to be compared with the ledgers and initialed by some one other than the bookkeeper before they are handed to the customer, and in some banks customers are requested to fill out and return a memorandum confirming the balance.

A number of banks, more particularly in the West, have adopted a system of stating depositors' accounts which is superior to the pass-book settlement. Their practice is to prepare monthly statements of all accounts; these are mailed to the depositors with the paid cheques or vouchers. This plan has the merit of enabling the auditor to verify all the depositors' balances at the same date, as he can compare the statements therewith, enclose a request for confirmation of their correctness and mail them himself, thus insuring the best check which it seems possible to devise.

It will be observed that the view adopted here with regard to a bank audit is that the verification of certain details may, and indeed must, to a large extent be left to the staff audit. The recent frauds upon the Bank of Liverpool, which paid upwards of $850,000 upon cheques forged by one of its ledger clerks, may perhaps raise a question as to whether this reliance upon the system of internal check is altogether justified in practice. It is thought, however, that the Liverpool frauds have little, if any, bearing upon the point, in that the system of internal check seems to have been chiefly conspicuous by its absence, or at least by its inefficiency. Three of the fundamental rules of any effective system are: (*a*) That no clerk should have access to books recording entries which go to check the entries kept by that clerk, *e. g.*, tellers should not be permitted to keep or assist in keeping any of the ledgers or taking off trial balances thereof. (*b*) That the clerks should be shifted about at frequent intervals, so that a fraud—even if committed—may be speedily detected by a fresh clerk going over the same ground. (*c*) That no unusual entries, as,

for example, transfers, should ever be made without special authority. None of these rudimentary precautions appear to have been adopted in the case mentioned, and it seems safe to say that, had any one of them been in force, the frauds could not have been committed, or would at least have been discovered at a very early date. At the same time, as has already been stated elsewhere, it is always desirable that an auditor, when considering the exact extent of his investigation, should make careful inquiry into the system of internal check employed, and satisfy himself that the system theoretically in force is actually carried out in practice.

In dealing with bank accounts, and all other accounts of a similar nature, the auditor must never forget that his responsibilities are not confined to safeguarding the interests of the proprietors. His certificate is virtually—whatever it may be legally—a guarantee to the public that the accounts submitted are to be relied upon as being, in every respect, correct. It is not, of course, suggested that he guarantees the safety of the customers' deposits; but he would reasonably be blamed were it to transpire that a bank which he had certified as solvent was afterwards discovered to have been hopelessly insolvent at the time of such certification.

At first sight it may appear impossible for the auditor to act up to the position here indicated, but he must remember that, in reality, *the* test of an auditor's competency is in his ability to judge of the correctness of items by an exhaustive testing—not necessarily of the items themselves, but of their totals.

A few remarks concerning the revenue account will not be out of place. The items of interest constituting the gross profit must be carefully tested, especially as to the rate charged upon current transactions, and the interest and dividends upon securities owned must, of course, all be accounted for.

It will frequently be found that the banking house and fixtures are carried at a sum considerably less than their value, and this constitutes one of the secret reserves that many con-

servative bankers favor. The most recent instance is that of a prominent trust company in Philadelphia, which has erected a magnificent banking house (costing about $1,500,000) charging the cost thereof against current earnings during the three years in which it was being built, so that the property account represents the cost of the land only. It should be stated, however, that in this case the stockholders were notified of the intention to so treat the account. While frankly admitting that the abuse of secret reserves is to be deprecated, it must be remembered that a balance sheet is not—and does not purport to be—a statement of finally determined facts, but rather an estimate of a position of affairs which by its very nature *cannot* be accurately determined. As proof of this it may be mentioned that only a few banks in the United States carry any reserve for unearned discounts, yet in a large bank this is a very considerable item.

The time will probably come when all banks will be required to keep their accounts upon a more scientific basis, and the bank officer, who now freely criticises a customer's statement which takes credit for future earnings, will reach the point where his own statement will reflect conditions more in accord with the facts than is now the case.

The audit of Savings Banks will be, in the main, along practically the same lines as that of national or State banks, though naturally it will be found that the assets consist more of long-term investments, such as bonds, than of loans. Commercial paper or unsecured loans should not be found at all.

It will probably be found more practicable to verify the depositors' balances by sending out statements thereof, with provision for confirmation and return direct to the auditor at a special post-office box than by calling in pass-books.

In the foregoing remarks the desirable extent of the auditor's duties has been stated rather than the bare limits of his legal responsibilities; the latter question will, however, be

found more fully discussed under the heading of "The Liabilities of Auditors."

(*b*) TRUST COMPANIES.—During the past twenty-five years trust companies have increased greatly, both in number and importance, in the United States. In addition to acting in a fiduciary capacity and exercising trust functions, they are authorized in many states to transact a banking business. Their charters are usually more liberal than those of either national or state banks; even as to banking functions themselves they enjoy certain advantages over banks, being permitted, for example, to make loans on real estate, which national banks are not, though on the other hand they are not permitted to issue circulating notes and they are forbidden in some states to discount commercial paper. In at least one state, Illinois, banks are permitted on due compliance with provisions of the law, to conduct a trust department.

It follows that the audit of a trust company partakes in a large measure of the nature of a bank audit which has already been referred to under (*a*). To be thorough, however, the audit must not be limited to the banking department but embrace the trust, safe deposit and such other departments as may be conducted by the company under examination. The examination of the securities in the trust department, for instance, is just as important as the audit of the banking department.

The audit of the income and expenses of the various departments must likewise not be overlooked, though the exact procedure will be more or less dependent on the circumstances connected with each individual case and to a considerable extent on the system of internal check. The volume of routine detail in a large trust company is very great, but if a proper system is in use the examination of much of it may safely be omitted.

(*c*) INSURANCE COMPANIES.—The general corporation laws of the various states do not, usually, cover insur-

ance companies, and they must incorporate under special laws. These laws give the companies special privileges, but they also impose numerous restrictions. In most of the states there is an Insurance Department which is empowered to examine the affairs of all companies, local and foreign, doing business within the state. These departments vary considerably as to methods, and while the examinations made by some of them are thorough in their nature, yet their purpose is not in line with that of an audit conducted in the interests of stockholders. Like the examinations of national banks, these audits are not to be relied upon to prevent fraud or carelessness by the employees, because the chief object of the state examination is merely to determine the solvency of the company, and its observance of the state laws.

A number of the European companies have their American accounts audited and reported upon monthly, and this may form a valuable part of an auditor's practice. These monthly examinations are of the nature of a continuous audit, and should, of course, be supplemented by a more exhaustive audit at the end of the year.

The accounts of a FIRE INSURANCE COMPANY are usually not at all complicated, and it will be in order to outline briefly the more important parts of an auditor's work in connection therewith.

The income must be thoroughly checked. The agents' original reports form the basis of the premium income, and enough of them should be checked into the books to test their accuracy.

The remittances from agents should be properly recorded at once, and no opportunity afforded to the cashier to "hold over" remittances.

The total outstandings due from agents at the end of the period should be thoroughly verified. The detailed balances should be analyzed, and any accounts in arrears should be

taken up with the manager. It should be an invariable rule to have some one other than the cashier write the agents about their overdue accounts.

A considerable part of the income arises from investments; this can be checked thoroughly, and must not be overlooked.

Likewise the examination of the securities themselves forms an important part of the audit, and will be conducted on the same lines as with banks.

The vouching of the cash payments very often occupies a larger proportion of the time than should be given to it; of course, the work is important, but it may be noted that an analysis of defalcations in insurance offices discloses the fact that very few are in connection with fraudulent vouchers. It is perhaps enough to say that the loss, expense and all other vouchers should be properly approved and recorded, and if this is seen to, the payments will have been sufficiently covered. In connection with the payments there should be in force a good system of recording re-insurances, so that in case of a loss the re-insured portion will surely be collected.

The verification of allowances to agents for rebates, return premiums and commissions falls under the heading of vouchers. Some special knowledge is desirable in this connection, but with reasonable care these points can be satisfactorily covered.

The balance sheet items require very little explanation, and present no unusual features, with one or two exceptions. In most States the insurance departments will not permit furniture and fixtures to appear as assets in the company's reports, and for this reason very few companies carry this account. This is an instance of a secret reserve, although not very flagrant.

The principal item among the liabilities is that of unearned premiums, or, as it is usually termed, the Re-insurance Re-

serve. This must be calculated on the basis prescribed by statute or by the regulations of the insurance department. The basis most generally used is that of reserving 50 per cent. of the gross premiums (less re-insurance) on all unexpired fire risks running one year or less from date of policy, including interest premiums on perpetual fire risks, and pro rata percentages of the gross premiums on unexpired risks running more than one year from the date of the policy; the liability on perpetual policies is taken in at the amount of the deposit reclaimable by the insured.

Ample provision should also be made for losses adjusted and unpaid, and for all other losses which may be disputed or unadjusted, as well as for accrued taxes, unpaid expenses, &c.

A very good article on auditing insurance accounts, by George Wilkinson, C.P.A., appeared in *The Business World* for August and October, 1904, and will well repay reading.

The audit of a LIFE INSURANCE COMPANY will present very few unusual points. The distinguishing feature of these accounts is the actuarial valuation of the Company's liability to the policy holders. The auditor is not responsible for the accuracy of this valuation, but it is his duty to see that the accounts are duly prepared in accordance with the actuary's figures.

On account of the nature of the business the investments will be a very considerable item, and will be likely to include more real estate and other fixed property than is usually owned by any other undertaking. In most of the States the companies cannot purchase real estate except for their own occupancy, but as this has been construed to cover enormous office buildings, from which large rentals are received, and as foreclosure proceedings bring in numerous other parcels, it usually happens that a very fair portion of the assets will be represented by real estate. The income from rentals, &c., will have to be looked after carefully and the balance sheet

valuations should be supported by the appraisals of competent men.

The loans made by the company to its policy holders upon the assignment of their policies as collateral should be carefully checked, and the presence in each case of the policy properly assigned ascertained. These loans are supposed to constitute one of the best assets which life insurance companies possess.

As a rule, investments must be made in accordance with State laws, but an auditor can hardly do more than obtain a certificate from the company's counsel that the laws have been properly complied with. The valuation of the investments is also a most important matter; this is considered in Chapter VII hereof.

Insurance companies as a rule do not carry any liabilities on their books for accrued expenses, with the exception in some cases of an allowance for medical fees, because it is their custom to charge these expenses only as paid. Recently, however, the State examiners have recommended that proper reserves be carried for accrued salaries, rents, office expenses, taxes, bonuses, commissions, legal fees, &c. The plan is, of course, in the line of proper accounting.

The routine of the audit will differ but little from that of fire companies but the auditor will be wise to pay particular attention to the surrenders. Claims should also be more carefully looked at than is necessary in fire offices.

The audit of the investments will be a much more voluminous matter than before, and will require considerable care, both to see that the principal is intact and that the prescribed income has been received. As, however, the method of keeping investment ledgers varies very considerably with different offices, this matter cannot well be gone into in further detail.

ACCIDENT, TITLE GUARANTEE, GENERAL AND SPECIAL LIABILITY AND OTHER COMPANIES do

not raise any new considerations. The great majority of such accounts follow entirely upon the lines of fire companies, the principal variation being that the basis of calculating the unearned premiums or re-insurance reserve differs in some cases, *e. g.,* in the case of marine and inland navigation companies it is usual to set up as such reserve the entire amount of the gross premiums on unexpired risks. The business of health insurance, however, more nearly approaches that of life insurance, and actuarial assistance will be required for the determination of the value of the unexpired risks.

(*d*) INVESTMENT COMPANIES.—The accounts of these companies are probably as simple as accounts can well be. The ostensible purpose of such companies is to enable investors to spread their capital over a large field, and so, by the principle of average, obtain a better security for their principal without a corresponding sacrifice of interest.

The history of many of our mortgage and debenture companies has not been satisfactory from the investors' point of view, and an auditor's position here is a responsible one.

The auditor will require to see the original memoranda for all sales and purchases, and also to ascertain that all interest and dividends have been properly accounted for. Purchases *cum div.* and sales *ex div.* will probably be the most likely cases in which an irregularity may occur. Only income earned during the time that an investment is held should be credited to revenue, while *per contra* revenue is entitled to take credit for *all* the income earned during that period.

The valuation of investments is perhaps the most important function of the audit of investment companies. Under existing conditions, the auditor cannot, of course, prevent the directors issuing accounts stating investments at cost price (regardless of value) but he at least can—and certainly should—call attention in his report to anything that he considers to be an undue inflation of assets.

It is not always imperative that investments should be written down to market price. In the first place, the principle of averages may consistently be followed here, and it will suffice if the total market price be not less than the total cost price. If, however, there be a deficiency in this respect, it should be met, not by a revision of individual values, but by a setting aside of a lump sum to an Investment Fluctuation Account as a reserve against loss. This reserve may either be deducted from the amount of investments in the balance sheet, or separately stated as a liability. A reserve so created should, except in very special cases, not be reduced in subsequent years, except for the purpose of providing for the actual loss realized upon the sale of depreciated investments.

When the total market value exceeds the total cost price it is not at all desirable that the capital value of the investments be increased. To credit such an increase to revenue is clearly as incorrect as it would be to credit it with an assumed increase in the value of goodwill. There is no particular harm in writing up the assets and crediting the difference to a reserve *not* available for equalizing dividends, but it is much better kept in hand—at all events until the permanence of the increase be well assured—as a secret reserve, against which the company may draw in bad times.

With regard to the profits or losses arising from sales made during the period under audit, in the first place the dividend should be apportioned (from day to day) so that the actual capital profit or loss may be arrived at. Such profits and losses made during any one year should be treated in the aggregate; if the result be a profit, it is available for dividend; if a loss be the result, it should come out of revenue, unless an adequate reserve exists from which the loss may be taken. It is, however, highly desirable that profits made by changes of investments be taken to reserve, and not credited to revenue. Although if the directors of the company choose to pursue the opposite course they would doubtless be wholly within their

legal rights and the auditor could not do much more than to see that the profits on changes of investments are not reported as current income.

In bad times the conscientious auditor of investment companies has an unthankful task before him, but he must not shrink from the responsibilities of his situation.

It is important to distinguish between investment companies and speculative finance companies. The chief profits of the former are income derived from investments, and profits derived from a change of investments only arise incidentally. In connection with the latter the profits derived from a change of investments form the main source of income; consequently all such investments must be regarded as so much stock-in-trade—as current assets—and valued accordingly, whereas the investments of a *bona fide* investment company may fairly be treated as fixed assets. The importance of this distinction lies in the fact that whereas the investments of a speculative finance company ought *never* to be valued at a price in excess of the current market price, it is frequently difficult (if not impossible) to arrive at any reliable basis of valuation; for stock exchange quotations are by no means necessarily a reliable basis, if there be no free market. Again, it may be pointed out that, following the ordinary principles of the valuation of unsold stock, no appreciation in the value of investments ought to be credited to revenue until those investments have been actually sold. It is not, however, necessary to write down each separate investment that has depreciated, while writing up those that have appreciated; the proper course would appear to be to maintain the investments in the balance sheet at cost price, making provision for a reserve sufficient to cover any deficiency in the aggregate intrinsic value, as contrasted with the aggregate book value. Realized profits may, of course, be properly credited to revenue; but care should be taken to see that they have been actually realized in cash, and, so far as possible, the auditor should be upon his guard against

the inflation of profits by means of "accommodation" transactions between different members of a group of companies. Probably the Whitaker Wright frauds will be sufficiently fresh in the minds of readers to make unnecessary any detailed explanation of what is alluded to under this heading.

This whole point was very carefully covered and clearly stated in Mr. Dickinson's paper, "Profits of a Corporation," already referred to. The section is reproduced in full, page 224 hereof.

To sum up, it appears that although, so far as the authorities have hitherto gone, it would appear that under some circumstances dividends may be legally declared out of current revenue without first making good depreciation of investments, it is, on the other hand, certain that the declaration of such dividends is a direct violation of every principle of sound finance, and should at all times be discouraged by the auditor who should make sure that the true position of affairs is sufficiently revealed to the stockholders either upon the face of the accounts or by a special clause included in his report.

(*e*) STOCKBROKERS.—A considerable amount of mystery appears to envelop stock exchange accounts, and the remark has frequently been made that the audit of brokers' accounts is altogether too technical a matter to be safely conducted by the general practitioner. The advantage of special practical knowledge on the part of the auditor has already been freely admitted by the authors, but it is contended that the desirable knowledge may be readily obtained, even by the general practitioner; and, with stock exchange accounts in particular, it is suggested that the necessity of "specialism" has been greatly exaggerated.

It is, however, essential that an auditor should have had some acquaintance with brokers' books before attempting an audit, and this can frequently be gained by the special work which they require at especially busy periods.

Brokers' books differ widely from the usual books of account. Many use a cash journal which serves as a daily record of all cash and securities received and delivered. In this book the left-hand page contains the receipt of cash and the delivery of securities, while the right-hand page represents cash payments and receipts of securities, or *vice versa*.

The subsidiary books also vary materially from commercial books, and some little experience is valuable, and perhaps essential, before attempting to audit them.

In the large New York houses initials are used for all active stocks, which is not only confusing, but requires considerable memorizing before any attempt can be made to verify the books.

As in a bank, a large force must be put on without notice, and, as the stocks will have to be "balanced" before many changes occur, this will mean quick and accurate work.

For the benefit of those not familiar with stock exchange transactions, it may be said that all big brokerage houses carry large lines of stocks and bonds for customers "on margin." These are in turn hypothecated with their banks as collaterals for loans. It is necessary, therefore, to go through the customers' ledgers and prepare a list of all stocks and bonds to be accounted for, taking into account the "shorts" as well as "longs." Lists must then be prepared of the stocks and bonds deposited with the banks, and the securities verified by correspondence, those on hand in the "box" must be examined, and the stocks at transfer offices checked. If everything is in order the lists will balance.

In an active market all this must be done within a very few hours or the verification will be worthless, as the changes will be too numerous to follow.

Customers' accounts at the first end of the month after the audit commences should be mailed by the auditor, and the confirmations, which are usually addressed to the client, should be secured before being opened by the clerks.

The custom of having the confirmations mailed direct to the auditor has made satisfactory headway during the last few years.

Testing the charges for interest and commissions may disclose a fruitful source of errors, as it is not unusual to discover inaccuracies which will repay the cost of the audit. These can readily happen on busy days, as it is not possible to prove the calculations except by going back over them, and this is not always done.

For the audit of these accounts to be of any value, however, it is necessary that it should be of the most detailed description; the danger of error or fraud—either of which might assume alarming proportions—is extremely great, and the utmost care and circumspection are, therefore, imperative.

Perhaps the chief danger in this class of audits lies in the fact that in the great majority of offices there exists no regular system affording a reliable internal check, and no efficient supervision. To remedy this obvious weakness the visits of the auditor should be frequent, say, at least twice during each year; indeed—although a "completed" audit is doubtless useful, as affording a reliable periodical statement of accounts—the only really efficient audit of stock brokers' accounts would appear to be one that is both detailed and continuous.

CHAPTER IV.

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS.

(Continued.)

IV. PUBLIC SERVICE CORPORATIONS.

The recent agitation in the United States with regard to municipal ownership of public utilities has aroused considerable interest in the methods of keeping the accounts of such utilties and preparing them for publication. So far municipal operation has not proved so successful as municipal ownership coupled with private operation through leases, and it is probable that the latter plan will prove more desirable for some time to come. Furthermore, the great majority of public utilities in this country are still being operated under franchises, many of them perpetual or practically so, granted to private corporations.

The day may come, however, when all public service corporations, at least in the more populous States, will be under the supervision of a State Board, or Commission, empowered to fix rates and compel reports prepared along uniform lines. The State of New York enacted laws in 1907 creating two Public Service Commissions (one for the counties of New York, Kings, Queens and Richmond, and the other for the remaining counties of the State) which in addition to other broad powers were vested with the power to prescribe uniform sys-

tems of accounts for the electric railways, gas companies and electric light, heat and power companies operating in the State. This power has been exercised, classifications of accounts for the three classes of corporations mentioned having been promulgated by the Commissions.

The most notable case of public regulation is that of the Interstate Commerce Commission, appointed under authority of Congress to supervise the operation of steam railways doing an interstate business. The results—so far as encouraging, and in some cases compelling, the keeping of and submitting accounts prepared along uniform lines—have been wonderfully successful, and part of the prosperity of our railways is no doubt attributable to the increased attention which has necessarily been given to the accounting departments of the railway corporations which have been subject to this control.

By amendments made to the Interstate Commerce Act in 1906, the powers of the Commission were very much broadened, its jurisdiction being extended to cover electric railways, express companies, sleeping-car companies, carriers by water (as described in the act) and pipe lines (excepting water and gas) transacting an interstate business. In addition to other far-reaching powers, including the fixing of maximum rates, the Commission is now empowered, not only to call for uniform reports, but also to prescribe a uniform system of accounts for each of the transportation agencies named, deviation from which becomes a penal offense. It is of particular interest to accountants that the classification of accounts for steam railroads promulgated by the Commission requires that entries for depreciation of equipment be made and it is to be expected that in due season such depreciation charges will require to be made for other parts of the physical property in which depreciation undoubtedly occurs. This official recognition by an important governmental body of a principle for which accountants have long contended is a " sign of the times " and should assist in convincing our courts when the question of deprecia-

tion comes up for judicial determination that it cannot be considered otherwise than as a charge to be reckoned with and provided for before stating net profits or paying dividends.

In the case of local public service corporations, State Legislatures can readily and in some cases have, passed the necessary acts delegating to commissions or municipalities the power to fix rates.

This puts a responsibility on an auditor which is far more serious than when he is dealing solely with stockholders and other owners, for now he finds himself not only in the position of safeguarding the interests of the owners, but he also occupies a quasi-public position. The accounts to which he certifies should not be so conservative that the profits are unduly diminished and the public deceived; nor, on the other hand, should they be so lacking in proper reserves and depreciation allowances that the profits will appear too large, and the attention of the consumers will consequently be called to this fact, with the result that agitation for rate reductions will naturally ensue.

This matter received the attention of the Congress of Accountants held at St. Louis in September, 1904, and the attention of the student of public utility accounting is therefore called to the published proceedings of the Congress.

It is not amiss in this connection to report the findings of a special committee appointed to pass upon this subject.

"The committee appointed at the Congress of Accountants, held at St. Louis, U. S. A., in September, 1904, to review the paper by Robert H. Montgomery, C. P. A., upon 'The Importance of Uniform Practice in Determining the Profits of Public Service Corporations Where Municipalities Have the Power to Regulate Rates,' having taken the paper into consideration, have come to the following conclusions, and now beg to state the same as their opinion upon the questions raised:

"I. A distinction must be made between the profits of an undertaking from the point of view of the general community and the profits available for dividends from the point of view of a corporation owning such undertaking. The former would be the net earnings from

the operation of the undertaking, after providing for all waste or depreciation of capital assets arising directly out of such operation; while the latter would only be arrived at after providing also for any possible loss on capital assets arising from causes not directly incident to such operation and for interest on borrowed money.

"II. The Net Earnings of a Public Utility with which the general community is concerned are determined by the excess of Gross Earnings over Expenses, defining the latter terms as follows:

Gross Earnings consist of the charges for all services rendered during the period as distinguished from mere receipts, but would exclude incidental earnings not arising out of the operation of the utility, such as interest on investments.

Expenses consist of:

(1) The direct cost of operation and of maintenance (ordinary repairs), expenses of management and provisions for bad debts, damage claims and rebates, as well as extraordinary expenses incurred during the period, such as legal charges, etc., but they should not include interest on borrowed money, discounts on bonds issued, or other charges in connection with the promotion or financing of the undertaking.

(2) Depreciation—

(*a*) On plant—physical—covering wear and tear, including direct requirements for renewals, etc., arising both from known and probable causes, such as electrolysis, &c.

(*b*) On plant—indirect—due to obsolescence and the like, but not that due to a fall in value from general causes.

(*c*) On other capital assets which are diminishing in value as a direct result of the operation of the property, such as moneys properly expended in acquiring from the local authorities the franchise under which the utility is operated where such franchise is, as is usually the case, terminable after a certain number of years; or cost of mines, quarries or other similar properties which are being used up continuously for the purpose of operating the utility. But there should not be included any provision for recouping promoters' profit or other watered capital, or for possible loss by reason of a general fall in values, &c., on the purchase at the end of the franchise of the whole undertaking by the public authorities, *i. e.,* the State or Municipality.

"III. In dealing with the private accounts of a corporation operating the utility, Earnings will also embrace miscellaneous receipts, if

any, not connected with the actual operations of the undertaking, and the following additional expenses should be allowed for, before arriving at a balance available for distribution:

(1) Depreciation—An additional amount to cover any excess of the book value of good-will, franchise and plant over that provided for under Section 2, sub-section *c* above, or over the sum it may be expected to realize on the expiry of the franchise.

(2) Interest—On bonds or other funded or floating debt.

"IV. In determining the rates which should be charged to the public, regard must be had (*a*) to the profit ascertainable under Section II., and (*b*) to the further charges specified under Section III., which would have to be borne by the corporation out of such profits. For instance, if eight per cent. per annum on the capital invested is considered a reasonable rate for a corporation to earn, taking into consideration the risks in Section III., then the rates should be fixed so as to allow of a profit of eight per cent. calculated as laid down in Section II., and out of this profit the corporation would have to provide for the risks and expenses stated in Section III.

A. Lowes Dickinson,
Elijah W. Sells,
Harvey S. Chase,
Ernest Reckitt,
John B. Niven,
Robert H. Montgomery, *Chairman.*"

It will be noticed from the foregoing that the most important matter, from the auditor's point of view, is the division of all expenditure into two classes—capital and revenue. It is not, however, always possible for the auditor to judge as to the correctness with which, say, the cost of an improvement, or renewal, has been apportioned as between capital and revenue; nor, indeed, is it necessary that he should attempt to constitute himself an engineering expert. He will, however, require to see that the company's engineer has certified the apportionment to be correct, and that the expenditure on capital account has been properly authorized. In addition, it is desirable that he should satisfy himself that the principle followed by the engineer in arriving at his apportionment is a sound one. There is, properly speaking, no "safe side" in these matters—an undue charge to capital is unfair to the proprietors, while an

undue charge to revenue is (through increasing the apparent cost of the service rendered) an injustice to the consumers. The following examples of apportionment will, however, be found useful, as indicating, in general terms, the correct method of arriving at the amount chargeable against capital, and against revenue, in any special case that may arise:—

New Works (including extensions): Capital.

New Works in Place of Old Works: Charge original cost of old works pulled down, less value of old materials, against revenue; charge the remainder against capital. (This amounts to debiting capital with total cost, debiting revenue and crediting capital with original cost of old works, and crediting revenue with value of old materials sold.)

The above description accurately explains the theoretical apportionment of expenditure on renewals as between capital and revenue; but, for practical purposes, it is important to bear in mind that the cost of any kind of construction work does not remain constant over an extended period. Assuming it did remain constant, no modification of the principle already described would be necessary; but, inasmuch as variations in cost are to be expected, it is claimed by many practitioners that only the *bona fide* "betterment" can be properly capitalized. Thus, if assets which originally cost $100,000 were, on renewal, to cost $125,000, the *whole* of the cost of such renewal would be a revenue charge. If, however, the assets which originally cost $100,000 were replaced by assets of a higher revenue-earning capacity at a cost of $150,000, the correct method of apportioning this $150,000 would be, in the first place, to ascertain what the exact re-instatement of the original assets would have cost, to charge that sum to revenue, and to only capitalize the excess.

There is reason to believe that in the past this rule has not always been applied with sufficient strictness to all companies. In new countries the cost of construction work has, owing

to facilities for transport and improvements in methods, been materially reduced of late, and thus the question arises as to whether the same principles may be fairly applied. If they were to be strictly applied, it is clear that pure renewal work, involving no "betterment" whatever, would indirectly result in a credit to revenue, in that the original amount of capital expended would be maintained in spite of the fact that capital assets actually existing to represent it had cost less. Thus, an asset which originally cost $100,000, and which was renewed (without detriment) at a cost of $80,000, would still be included in the capital account at the former figure. The proper method would, under this theory, be to write down the book value of the capital account as and when renewal work is undertaken at a reduced price.

The policy which is more generally followed in the United States, however, does not agree with the foregoing views. It is argued that the best practice requires, or at least permits, the plant account on the books to represent the *last* cost; that is to say, if assets which originally cost $100,000, on renewal cost $125,000, the excess is properly chargeable against capital, the best proof of the soundness of this position being the attitude of insurance companies with respect to paying claims for fire losses; it should be remembered that the matter of insurance is a vital one to every business; therefore, the books should be arranged so that they will influence a fair settlement in case of fire, provided, of course, that sound accounting principles are not violated. The theory of insurance is that the insurance company will bear the cost of replacing the article destroyed (having regard to its condition at the time it was destroyed); therefore, if the books show the last cost of the plant, it will be easy to arrive at an equitable adjustment by using the book values less a fair rate of depreciation. If it were found in the instance cited above that $25,000 had been debited to revenue and the asset stood on the books at $100,000, the owner would probably have difficulty in proving his claim for $125,000.

The question must also be considered from the standpoint of the return which a public service corporation would be entitled to earn on the capital invested. It would certainly seem that the depreciation on plant which forms an item in the cost of the service rendered (see Section 2, sub-section 2 (*a*) of Committee's report, page 135 hereof) should be based on the cost of the plant actually used therefor, which would necessarily include the last cost of any parts of the plant which might have been replaced since the inception of the operation.

In other words, it is claimed that *cost* is the only correct basis, for it must be assumed that an undertaking builds or replaces its plant at the lowest cost possible, and, if through any contingency, commodities increase in value and certain renewals cost more than the original assets, it is quite enough to charge the latter against revenue and allow the asset account to represent actual cost of the existing plant.

CONVERSIONS.—In case old materials, instead of being sold, are used for other purposes on the works—treat the particular department of capital expenditure as the purchaser of the old materials in question, debiting it with the value of the materials and the full cost of conversion (if any).

There are some special features connected with public utility enterprises which will be considered under their appropriate headings.

(*a*) GAS COMPANIES.—The income of a gas company consists of gas sales, residuals sold, and generally profit on fittings and rents, in addition to interest on investments. The collections of gas sales are best checked in totals (care being taken to fully test both allowances and arrears), the total receivables being arrived at from the meter readings books, which will show the total amount of gas consumed and what meters are in use. The residuals sold cannot well be checked as to quantity (save by comparing the results of various working statements), but, of course, the auditor may, and should, check the collection of the amounts debited. The same remark ap-

plies to fittings, which will almost invariably be found to form a part of a gas company's business. It may be added that it is best merely to state the profit arising from fittings on the credit side of the revenue account (rather than to credit revenue with income, and to debit it with expenses). The leading items of expenditure arise from coal and other fuel, stores, and wages; the latter has already been considered in Chapter I., and the former in Chapter II., and need no further consideration beyond saying that both must be fully vouched, and carefully tested. The question of depreciation should be carefully considered in connection with gas companies, because a considerable part of the plant must be wholly renewed at comparatively short intervals. A provision must, therefore, be made for these renewals.

The investments held against reserve, insurance, and (if any) depreciation funds, must be verified by an inspection of the securities held.

This leads up to the consideration of the depreciation fund (in reality a sinking fund), which must be accumulated by companies owning works on leasehold lands. The case will not often arise, but, when it does occur, a sufficient sum must be set aside, and invested to accumulate to the cost of the works by the time the lease expires. The auditor should satisfy himself as to the sufficiency of the annual instalments.

The auditor of a gas company should be thoroughly familiar with the system of uniform accounts submitted to the American Gas Light Association at its annual meeting in 1902, and with the later amendments thereto. The report covers the "Classification of Operating Expense Accounts; Classification of Betterments or Property Accounts; Forms of Monthly Journal Entries and Rules for Closing." While certain features of this system can be improved upon, especially the nomenclature, it forms a valuable basis for an ideal system.

The Public Service Commissions of the State of New York have issued elaborate classifications of accounts for gas com-

panies, which companies operating in that State are required to use.

(*b*) WATER COMPANIES.—The audit of water companies is slightly simpler than that of gas undertakings, by reason of the fact that the rates charged are, for the most part, fixed, instead of fluctuating with the quantity used. Such portion as is supplied by meter, for trade purposes, will entirely follow the method recorded under gas companies. With regard to the greater portion, which is based on a sliding scale, it is not usual to exhaustively check the calculations involved, but they should be *tested* to such extent as may appear desirable. Vacancies may sometimes be vouched by a declaration of the owner that the property in question has been vacant for the whole of the quarter. Allowances (which should be very exceptional) must be properly explained, while arrears and bad debts must both receive careful attention.

Most companies are empowered to make their charges in advance, and consequently their books will, at the date of the accounts, reveal a profit that has not yet been earned; due allowance must, of course, be made for this in the general balance sheet.

GAS and WATER COMPANIES (combined) will—in almost every instance—be found to keep the accounts of the two undertakings separate. In the few old companies where no such practice exists, separate accounts should, at least, be made out for capital expenditure and revenue (the management expenses being apportioned according to, say, the ratio of the average gross income from each department), so that the profit upon each may be known and the proper working statistics prepared.

(*c*) ELECTRIC LIGHTING COMPANIES.—The general method of audit will practically follow the lines indicated under the head of Gas Companies; especial care should, however, be directed to the correct apportionment of expenditure between capital and revenue.

Care should be taken to see that all proceeds of sales of lamps, &c., are accounted for and proper stock accounts kept.

Electric light accounts differ from those of most other undertakings in that the perishable nature of the fixed assets renders it imperative that special attention should be devoted to the subject of depreciation. It is not merely sufficient that the working plant should be fully maintained in a state of working efficiency out of revenue, as the high speed at which the machinery is run, combined with the fact that only the smallest possible intervals of rest can be afforded to rectify defects, very materially shortens the duration of the life of these assets. Moreover, in connection with this particular industry the advances of modern science are so rapid that, in spite of this comparatively short time of life, many parts of an electrical plant become obsolete before they are worn out. For these reasons a high rate of depreciation must be provided, and it is now being realized that in most cases depreciation has occurred at a more rapid rate than has been provided for in the accounts.

It is thought that a minimum safe provision against depreciation of the actual expenditure as a whole would be one equal to five per cent. on the total capital expenditure. In the English editions of this work the minimum stated is four per cent., but general opinion seems to require a somewhat higher rate in the United States. It may be added that five per cent. allowance for depreciation on the entire cash investment is the minimum figure used by a prominent American electrical engineer who has made a careful study of conditions in every part of the United States; in the case of one ten-million-dollar plant he claims that the annual depreciation rate should be nine per cent. It is of interest to note that of the British municipal corporations which appear to have been among the first to appreciate the importance of adequate provision for depreciation, Glasgow provides—on machinery, seven and one-half per cent.; accumulators, ten per cent.;

mains, two and one-half per cent.; meters, six per cent.; instruments, five per cent.

One caution in conclusion may not, however, be out of place: where no regular purchase ledger exists—and this state of affairs will also be frequently found in connection with both gas and water companies as well—particular care will be necessary to guard against any omission of outstanding liabilities, when the annual accounts are prepared.

V. TRAFFIC ACCOUNTS.

(*a*) STEAM RAILWAYS.—Railway accounting in the United States has reached such a high state of perfection, that the auditing department usually has at its head a thoroughly competent official. During the past few years, audits of the accounts by professional accountants have been increasing and it is thought that the time is not far distant when railroad stockholders will not be satisfied unless an independent examination is made on their behalf. Until the promulgation of the Interstate Commerce Commission's revised classification of accounts in 1907, of which mention has already been made, it was not customary to make any systematic allowance for depreciation, and there is still a remarkable lack of uniformity with regard to writing off so-called betterments. The Commission has, however, issued a tentative classification of Additions and Betterments Expenditures which will doubtless be succeeded later by a formal classification to be used by all roads. If definite standards of extensions, additions and betterments are set up and the accounts stated accordingly, this is really all that can be expected, as it will be conceded that, if they act in good faith and violate no accounting principles, the directors must be permitted to dictate the policy of the company, even though it be ultra-conservative. If the stockholders are fully informed and want a different policy pursued they have the power to bring about a change.

A few remarks on the routine work are in order: The auditing department, in itself, constitutes a continuous and

thorough check upon every other department under the supervision of the controller, and, as no moneys whatever pass through that office, it may safely be taken that the work is honestly performed.

The professional auditor's work may thus be said to commence with the certified returns of traffic, and the certified vouchers for expenditures made. He must, however, himself examine and verify the summaries of these items. He must see that they tally with the cash and notes received, and that the latter find their way into the bank in due course. He must examine the vouchers of all expenditure, and, so far as possible, verify its apportionment; in particular must he satisfy himself as to the correctness of the apportionment of such expenditure between capital and revenue. With regard to the issue of new capital, he must see that the amount actually received agrees with the totals shown in the stock ledgers kept at the secretary's office. He should compare the certified returns of "foreign" railways with the entries in the books of his own company. He should check the transactions in notes in detail, follow the matured notes into the banking account, and verify the outstanding notes by the inspection of the actual documents. He must check the traffic outstandings with the certified statements, examine the entries on both sides of the banking account, and check the additions, and, so far as possible, the classification of the items. He should examine all bonds that have been redeemed, and see that they have been cancelled. He should also see that all paid coupons have been cancelled and properly filed. He should examine the accounts for repairs made to the rolling stock of private car lines and compare the lists with the ledger. He should examine the accounts of rent received, thoroughly check the general ledger, compare the balances of the various stock accounts with the certified list of stores on hand, and compare the totals of the general ledger expense accounts with the totals of the subsidiary books. It will then still remain for him to ascertain that such liabilities as traffic drawbacks are

provided for, verify the investments by inspection of securities and examination of the interest received, compare the capital issued with that authorized by stockholders' minutes, give a final consideration to the apportionment of capital and revenue expenditure, and see that the necessary certificates have been furnished as to the efficiency of the permanent way, rolling stock, &c.

Of course all of the above details cannot be covered in the audit of one of the great trunk line systems. In such a case, however, the internal check is likely to be more efficient. As with other undertakings, the auditor must be governed by the special circumstances of the case, and should only omit such details as are checked intelligently by independent employees.

Any one interested in the accounts of steam railways should by all means read the addresses relating thereto by Prof. Henry C. Adams, in charge of Statistics and Accounts, Interstate Commerce Commission, and Arthur W. Teele, C.P.A., delivered before the meeting of the American Association of Public Accountants, held at Atlantic City, October, 1908, and which appear in its 1908 year book.

(*b*) ELECTRIC RAILWAYS.—In 1898 the Street Railway Accountants' Association of America (now known as the American Street and Interurban Railway Accountants' Association) recommended to its members a standard classification of accounts prepared by a committee of the Association. This classification has been adopted by the majority of street railway companies and has also been prescribed by quite a number of railroad commissioners for use in making reports to the State. During the past year the Interstate Commerce Commission has issued a more elaborate classification (at least for the larger corporations) and while the number of electric railways which are under its jurisdiction is comparatively small, the classification may come into general use through being adopted by the various State commissions having jurisdiction. The New York Public Service Commissions also issued revised and amplified classifications during 1908, the use of

which is compulsory for railways operating in that State; these classifications were patterned to a considerable extent after that of the Interstate Commerce Commission.

The auditor should make himself familiar with the classification in use before commencing an audit of a street railway. The audit, however, is rather simple, as the business may be said to be on a "cash" basis.

The audit of the receipts is of the utmost importance. The daily returns will usually be found to be certified to. An examination of the system will develop whether this can be depended upon. If so, the daily receipts should be traced into bank. It may, perhaps, seem superfluous to suggest the propriety of seeing that receipts are accounted for upon every day of the year. It will be found in nearly all cases that the entire daily receipts are deposited, which is, of course, the only proper way, and if it should not be in force the change should be made instantly. Other sources of receipts should be inquired into, and it may prove to be a fruitful inquiry, for in many undertakings, where a most rigid system exists of looking after the usual transactions, infrequent items of revenue, such as sales of old materials, &c., receive scant attention, and numerous cases are known of these sales being unaccounted for.

The question of the proper method of treating ticket sales is also one to be considered in connection with railway accounts. From a purely theoretical standpoint there can be no question that ticket sales only become actual revenue or income when the service to which the purchasers are entitled is rendered; consequently the credit arising from ticket sales should go to a suspense account (stated in the balance sheet as deferred or unearned income) and transfers made, say monthly, to the appropriate earnings account for the tickets "lifted."

In many cases, however, where the ratio of ticket sales to cash fares is small the outstanding tickets are a negligible

quantity. In other cases, however, they may run into large amounts; in a recently published balance sheet of the street railway company of one of the large cities the liability stated for uncollected tickets was over $90,000. Many companies, however, ignore the outstandings entirely and include the entire amount of sales in the current earnings, pointing to the example of the steam railroads, with which this custom is nearly universal, as a justification of the practice. In the latter connection it should be noted that the Interstate Commerce Commission makes an exception in the case of interchangeable mileage books, permitting the mileage therein to be credited to earnings only as honored.

It should be noted that the inaccuracies in the gross earnings account, due to the failure to take cognizance of uncollected tickets, will be greatest for some time after making changes in kinds of or methods of selling tickets, also when special tickets are being sold for a limited time.

The only other source of revenue of any importance will be advertising; but, as this is almost invariably sub-let to an advertising agency, it needs no comment.

The expenditures—which should always be made by cheque, no payment out of traffic receipts being on any account permitted—must be carefully vouched; while the analysis thereof must, so far as possible, be verified. In particular, the apportionment between capital and revenue must be thoroughly scrutinized.

It is only a few years since street railway men and even some professional auditors claimed that it was quite unnecessary to provide for depreciation in street railway accounts. By some it was claimed that the current renewals to keep the property in good operating condition were a sufficient charge to operating expenses, while others claimed that the enhancement in the value of the franchises held offset any depreciation in the physical property.

If the directions laid down in the uniform system are properly carried out, and if renewals were uniform from year to year over, say, twenty years, it might, perhaps, be claimed with some show of reason that, so far as the current operating accounts at least are concerned, there was no necessity for providing directly for depreciation.

It frequently happens, however, that the first examination the auditor makes follows immediately, or very closely, the reconstruction of the road, or its consolidation with other lines, or with electric light companies. During this period the charges to construction will be heavy—legitimately so—and the direct charges to repairs and general maintenance light. It is contended that the only scientific way to prepare the accounts of such a year is to include an allowance for depreciation. If this is not done, it almost invariably happens that in later years, when the renewal charges are heavy, the necessity arises for capitalizing these large expenditures, and where there should be ample reserve to provide therefor, laid aside out of earnings, there is not a dollar in hand for this purpose, and the fact that the dividends paid were in fact out of capital develops too late.

It is, however, becoming recognized that electric railways are no exception to the economic rule that use of plant is inseparable from depreciation and exhaustion. It is immaterial whether the plant is that of a manufacturing establishment or that of a railway; the exhaustion through use is going on just as surely in the case of the latter as in the case of the former. Again, there is probably no other industry in which obsolescence has operated to render property useless for operating purposes more rapidly than in the electrical field. The classification of accounts recently prescribed for electric railways by the New York Public Service Commissions provides for depreciation charges; the Interstate Commerce Commission's classification likewise takes cognizance of the necessity of provision for depreciation. Such recognition of the fact of the existence of depreciation and the necessity of providing

therefor is encouraging, and is, in some measure at least, a tribute to professional accountants, who for a long time were almost alone in their stand for the recognition of this principle.

It is within the province of, and it is in fact the duty of, the professional auditor to take a firm stand upon this question, and to refuse to certify the profit and loss statement of a street railway company which does not amply provide for depreciation—either directly or by satisfying himself that the charges for renewals represent a fair equivalent. If he is unable to secure this result his certificate should draw prominent attention to the fact, and it must follow ultimately that the protest will be heeded.

The opinion of an engineer on the question of depreciation of electric trolley railways is of value to professional auditors. The following extract is from a report made by a prominent engineer. The undertaking in question is a small one, but it is not likely that the figures would be altered in any event. Pole lines and copper, ten per cent.; ties, twenty per cent.; machinery, ten per cent.; cars, twenty per cent.

During the past few years interurban electric railways have developed rapidly, and in some states, particularly in the middle West, there is now a perfect network of them. Running through the open country—often on private right of way between cities and town—they frequently have a mileage comparing favorably with that of the smaller steam roads and construction equalling steam roads standards. In addition to the short haul passenger traffic of the ordinary urban street railway, there is long distance passenger business and freight and express traffic to be handled.

These conditions necessitate accounting methods—and consequently auditing methods—which approach closely those in use on steam roads. Where the road is a large one it will naturally have an auditing staff of its own which will take care

of the routine auditing of traffic receipts, and the professional auditor's course of procedure will be much like that outlined under (*a*) Steam Railways.

(*c*) SHIPPING COMPANIES.—Unlike the accounts of railways, the accounts connected with marine traffic are subject to no uniform recommendations with regard to form.

There are comparatively few shipping companies operating in the United States, but the subject is, nevertheless, of interest.

There is no essential difficulty in connection with shipping accounts, but the fact that it is both desirable and customary to show the net result of every voyage of every ship necessitates some very nice apportionment of the items constituting shore expenses and insurance.

The extent of an auditor's investigations will vary greatly in different cases; in the case of a single ship it is desirable that the audit be as exhaustive as possible; but in the case of one of the larger companies such a course would be quite as impracticable as in the case of a railway. The actual extent in any particular case will thus be very largely a matter of arrangement and of expediency.

The following considerations may, however, be safely submitted, as they will in every case require to be dealt with in more or less detail:

Ascertain that freights and passage money are duly accounted for; that the apportionment of shore expenses is equitable; that the cost accounts are not improperly manipulated (especial care being required where one cost account is kept for a whole fleet); that only structural improvements are debited to cost account; that proper depreciation is allowed—especially in regard to boilers; that outstanding freights and agents' balances are provided for in accordance with the documentary evidence; that unclaimed return passages are in order; that proper return of insurance premiums has been ob-

tained for the time during which any vessel has been "laid up," and, generally, that insurance matters are in order; that the question of foreign exchanges has been dealt with upon a proper basis; and that no profits are taken credit for on account of uncompleted voyages.

In order to prevent misunderstanding, it seems desirable to point out, for the benefit of the reader who has no experience of shipping accounts, that the "Cost Account" is really neither more nor less than a capital expenditure account, and must on no account be confused with the cost accounts kept by manufacturers.

Some shipowners, instead of insuring with underwriters against risk of total loss or damage to their vessels, raise an insurance fund wherewith to meet such losses by periodical charges against revenue. The effect, of course, is that, instead of profit and loss being debited with insurance premiums, it is debited with an instalment—probably somewhat in excess of that which would have been thus paid—which is credited to the insurance fund. At the same time, to make the insurance fund really effective when required, it is desirable that a corresponding amount of cash should be invested in readily realizable securities, the insurance fund thus becoming for all practical purposes a sinking fund, rather than a mere reserve. When any loss is incurred, the cost of replacing it is debited to the insurance fund account, a corresponding amount of investments being realized to provide the necessary cash. It need hardly be pointed out that an insurance fund can only become an effective provision against loss in the case of companies owning a large fleet of vessels, so that within their own experience they get a reasonable average of risk. Even here, however, it will sometimes happen that a loss occurs which will more than swallow up the whole of the accumulated fund, and the question then arises whether it is reasonable to bring forward the *debit* balance of the insurance fund account as an asset upon the balance sheet. If there is a reasonable probability that this debit balance can be extinguished out of future

instalments within a short time, there might possibly be no objection to this course of procedure; but, in any event, it seems desirable that it should appear as a special item in the balance sheet, so that no stockholder may be deceived as to the actual position of affairs; and in addition the auditor should draw attention to the facts in his report.

Owners of single ships and single-ship companies almost invariably make no provision for depreciation; the auditor need not waste his time upon any efforts to convince his clients of the imprudence of this course, but he should not forget to append the necessary qualification to his report.

The auditor of single-ship companies must bear in mind that, as regards fraud, there is no such thing as "safety in numbers" here, for the accounts are usually all in one person's hands—let him, therefore, not omit to examine the voyage account book in detail. In a recent case it transpired that the same manager had control of the funds of several single-ship companies; and, by an ingenious process of "ringing the changes," was enabled for many years to conceal from the auditors the fact that there were serious deficiencies in his cash balance.

It is a good plan always to ascertain that no mortgage has been registered against the ship which is not recorded in the books.

The professional accountant who endeavors to acquaint himself with all of the ramifications of the accounts of public service corporations, and who is interested in the subject of municipal *v.* private ownership, will find it necessary to read, or at least consult, the voluminous reports of the National Civic Federation on "Municipal and Private Operation of Public Utilities," issued in 1907.

VI. THE ACCOUNTS OF PUBLIC AUTHORITIES.

The whole subject of municipal accounting has received consideration attention in the United States recently, but it

cannot be said that there is any immediate prospect of the audit of these accounts in general being turned over to the professional auditor. It is sure to come ultimately, however. Therefore serious consideration should be paid to this subject.

The National Municipal League has done much to further the cause of uniform municipal systems, and the St. Louis Congress of Accountants also gave the matter attention. The proceedings of both bodies can be readily secured, and should be in the hands of everyone interested. When it is considered that practically each of our fifty States and Territories has different laws regulating the affairs of municipalities, the vast work undertaken by the National Municipal League will be appreciated.

The United States Bureau of the Census has during recent years taken an active interest in this subject, and through its co-operation with the other agencies which are working for improved municipal accounting methods has contributed materially to the progress which is being made. The Census Bureau's classification of revenues and expenses, based on that of the National Municipal League, has been adopted by quite a number of cities, which is in itself an encouraging sign.

With such an extensive field and complex conditions before him, the practitioner who has in mind making a specialty of municipal accounting will, of course, be compelled to make a rather exhaustive study of the whole subject, and anything short of a general review of what has been recently accomplished would be of little value; it is, therefore, unnecessary to explain that the limits of this book will not admit of further discussion.

The practitioner or student who desires to make an exhaustive study of municipal accounting would do well to secure the various reports on the system of accounts in use by the City of New York. These accounts have probably received more attention than any other accounting system in existence. In-

vestigation has followed investigation, and out of them all a system worthy of the name has at last seen the light.

The Bureau of Municipal Research of New York should have the principal part of the credit for this result, because its directors worked unceasingly for several years to bring about the much needed reforms.

A full and detailed description of the new system as approved by the Bureau has been published by the city, and any accountant interested can no doubt secure a copy.

It is believed that cities not nearly so large as New York may well follow some of the new features recently introduced, for—as was declared by the Chamber of Commerce of New York at one of its meetings—a proper system of accounts will "fix responsibility, expedite business, and eliminate waste."

The Chamber of Commerce, in its desire to ascertain whether or not the proposed system was based on these theories and was working out as well as was promised, appointed a committee consisting of one of its own members, together with Francis F. White, C.P.A., and Robert H. Montgomery, C.P.A., to examine and report thereon.

This committee spent several months in its investigation, and its report, containing a number of criticisms and recommendations, was adopted by the Chamber of Commerce in June, 1909.

With certain exceptions, chiefly technical, the committee approved the system in the following terms:

"We unhesitatingly assert that the general principles upon which the new accounting system rests are sound, and that their application to the accounts of the city cannot but be beneficial to a marked degree.

"The substitution of a thoroughly co-ordinate accounting system for the unscientific and incomplete one that has prevailed will not only pay for itself by enabling the Comptroller as well as the citizens to secure a knowledge of the exact

financial condition of the municipality, and thus furnish the essential data to secure economical administration, but will unquestionably raise the credit of the city."

VII. EXECUTORS' AND TRUSTEES' ACCOUNTS.

It will sometimes happen that the professional accountant is called upon to audit the accounts of executors or trustees, on behalf of some dissatisfied beneficiary, or, as is more frequently the case, he will be called in by the executors or trustees themselves, because they desire the certificate of an independent auditor that their accounts are correct.

The purport of the auditor's investigation in such cases will be to ascertain that the terms of the will or trust have been complied with, and that no improper use, or unauthorized investment, of the trust funds has occurred. Questions of apportionment between principal and income will also claim his attention.

The fullest investigation into details will be necessary, except, perhaps, that where the trustees have been authorized to carry on the testator's business and where there is no suggestion that their conduct has, in this respect, been improper, the business accounts may be excluded from inquiry.

In addition to the will and probate, and the accounts kept by the executors and trustees, the accounts filed with the court, together with the minute book (if one be kept) and all documents and vouchers, will require to be carefully examined.

With regard to the question of apportionment, it is important to remember that all interest accrued to the date of death (inclusive) forms part of the *corpus;* that the profit or loss arising from any subsequent *bona fide* change of investment falls, as regards principal, upon principal, and as regards income, upon income; that, even where investments of a wasting nature are specially authorized, the whole of the income does not of necessity pass to the life-tenant (where the will or deed

of trust provides that the wasting assets must be administered for the equal benefit of life-tenant and remainderman the usual custom is to consider five per cent. (or thereabouts) as income, and to capitalize the remainder); that any loss arising out of an unauthorized investment falls upon the trustees personally, who are liable to repay the amount with such interest as the court may direct—the rate being usually six per cent. (simple interest), and the same rate is usually charged where the trustees have applied the funds to their own use. Any of the above provisions may, however, be modified by the special terms of the will or other instrument creating the trust.

The investments authorized for trust funds (subject to any special terms in the will) have varied from time to time. The auditor will therefore require to satisfy himself that each investment was a proper one *at the time it was made*. The investments authorized by the several States vary as to their character, but usually consist of first mortgages upon real estate, Government and first lien railroad bonds.

It is also important to verify the commissions claimed or paid to the executors or trustees, both as to amount and especially to make sure that there are no duplications. An executor who has received a commission on the principal of an estate will not be allowed a second commission for subsequently acting as trustee of the same estate, and as a rule no commission is allowed on changes in investments.

It frequently happens that an estate is so bequeathed as to be divisible between persons of different ages, with the proviso that the share of each is to be held in trust for him until the happening of a certain event—such as his attaining his majority (or, in the case of a female, on her marriage)—the beneficiary in the meantime only receiving the income on his, or her, share. Under such circumstances it generally follows that the beneficiaries do not become simultaneously entitled to their respective shares in the principal; but the moment any one becomes entitled to a share in possession he becomes entitled to actually

receive his share, and—save by consent—the division (or partition) of the estate cannot be postponed. If the estate consists of investments that are readily capable of division, the problem is, of course, a quite simple one, for the beneficiary entitled to the partition may then have transferred to him (or sold for his benefit) his due fraction of each of the numerous investments held by the trustees; but when the estate includes mortgages, lands, or other non-divisible assets, some arbitrary method of arriving at the beneficiary's share becomes essential. If all beneficiaries are of age, the share of each may be mutually agreed; but if any one of the beneficiaries be under age, there is no means of obtaining his (or her) consent. The only course is then to apply to the court to direct a "partition" of the estate, and the ascertainment of the share immediately payable to the beneficiary entitled to a possessory interest, and the order of the court will be a protection to all parties concerned. Upon payment of the amount found to be due to the beneficiary, he ceases to have any interest in the trust estate, and the residue of the estate is then held in trust for the remainder of the beneficiaries, who alone are concerned in any subsequent fluctuation in the value of the trust investments.

It is especially important to remember that beneficiaries, unless of full age, have no power to consent to any variation in the terms of the trust.

In conclusion, it need hardly be pointed out that one of the most important duties in these audits consists of a very careful verification of the investments.

CHAPTER V.

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS.

(Continued.)

VIII. ACCOUNTS OF INSTITUTIONS.

(*a*) CHARITIES.—Under this head may be included the accounts of hospitals, certain endowed universities and schools, and similar institutions.

The distinguishing feature of most charities' accounts is the receipt of subscriptions and donations. These will, of course, require to be vouched in the usual way; but, perhaps, the most effective check consists in the publication of a list of subscribers and donors along with the accounts.

In the case of hospitals there will be a considerable revenue from patients' board, &c., which will have to be carefully checked. It is not always the custom to keep these accounts upon a double entry system, and abuses frequently occur.

There is no reason why the patients' accounts should not be as carefully kept and easily checked as the accounts of guests in a hotel. There is always a patients' register, giving time of arrival, &c., and the other books can be arranged conveniently to allow of a satisfactory audit.

It is unfortunate that the accounts of institutions receiving State and private aid should be lacking, as most of them are,

in uniformity and clearness. It is hoped that the increased attention which is now being given to uniform municipal accounts will extend to public institutions, and great benefit may be expected in this direction.

In some States where State aid is given to hospitals and other charities an official auditor visits the recipients and "audits" the accounts. It is the custom, however, for these officials to simply satisfy themselves that the State's appropriation to the particular institution has been properly expended, without regard to other sources of income and expenditure, and the books are, as a rule, arranged for his convenience. It is needless to say that such a system does not lend itself readily to the preparation of proper income and expense accounts. On the whole it will be found advisable to continue whatever forms the State examiners may require, but in addition there should be installed a proper system which will show the actual results of operation rather than a simple cash account.

The vouchers will probably be in very fair shape, as it is customary to have them examined, not only by the State examiners, but by committees of the Board of Directors, Managers, or Trustees as the case may be.

(*b*) CHURCHES.—In many respects the audit of church accounts is a peculiarly thankless task. Apart from the fact that they are hardly ever submitted to the auditor in anything approaching proper form, it is almost invariably the case that no effective internal supervision is exercised, and frequently large sums will pass through a Treasurer's hands without any proper check being kept upon his dealings.

The auditor must check everything he can, and try to teach his clients the elements of commercial caution; but it is probable that he will never feel *quite* happy with a church audit.

At a recent church convention it was proposed in good faith by a disinterested individual that in all parishes having a cer-

tain minimum income, the treasurer's accounts be submitted to a Certified Public Accountant for audit. Unfortunately the motion was voted down, but the seed has been sown, and no doubt the harvest will ripen at no distant date.

(*c*) COLLEGES AND SCHOOLS.—These accounts call for but little comment. The usual method of audit may be said to consist of a "cross" between that employed in "Charities" and "Hotels" (*q. v.*), but it may be added that only a detailed audit is likely to be found entirely satisfactory.

The income from tuition fees, room rents, &c., forms a large aggregate as a rule, but is usually recorded by single entry methods, and it therefore will bear careful checking. Obviously every student's name found in the annual catalogue must be accounted for, and it is sometimes found to be a good plan to report to the trustees all allowances and rebates, and the names of all "free" students. It may serve as a surprise to the deans, but the trustees will probably appreciate the report.

While it is not unusual for colleges to have professional audits, there is a wide difference in the methods adopted of stating the accounts, and there is a vast field for improvement. Most of the balance sheets and income and expense accounts are stated in such an involved way that it is hard to gather any definite information as to the actual *results* of the "operations." In view of the immense sums which are contributed annually it is to be regretted that more attention is not given to the accounts for the purpose, at least, of showing by comparisons and proofs that there has been a reasonable return from the "capital" employed.

It is possible that college accounting methods may undergo a radical improvement in the near future. The deficiencies of present methods are clearly set forth in a series of articles by Clarence F. Birdseye, Esq., published in *The American College,* and commencing with October, 1909. The student will do well to consult the articles "College Bookkeeping and Accounting" and "Analyzing the College Business."

IX. BUILDING AND LOAN ASSOCIATIONS.

The number of frauds—some of them of disastrous proportions—that have occurred in the accounts of building associations should suffice to make the auditor of these accounts more than usually cautious.

Although so far as known all these associations require the appointment of auditors annually, it has not been the custom to employ Certified Public Accountants, chiefly on account of the expense involved, but in view of the losses which have fallen upon stockholders in the past, it would seem that by this time an investor would no longer be satisfied with the amateur auditor. In any event, the auditor's fee would not be more than a small fraction of the association's annual income, and if the matter could be put before the investors in a proper light the great majority no doubt would insist on proper audits.

It will usually be found that the whole management of a building association devolves upon one man, who—besides having both books and cash under his entire control—turns the whole of the board round his little finger. Add to this the fact that the system of bookkeeping employed is often of the most primitive kind, and some idea of the responsibility of the auditor's position may be gained. The complexion of affairs is hardly improved where there is more than one real worker upon the staff; any efficient system of internal check is all but unknown (except in a few—a very few—of the best and largest associations), while the class of men employed is usually very different, and very inferior, to the class of men employed in banks for work of a very similar nature.

The great majority of frauds that have been committed have remained undetected by reason of the very superficial examination bestowed upon the accounts by the auditors; but cases have occurred in which the most detailed audit (conducted by unskilled men truly, but none the less detailed on that account) has failed to detect anything wrong.

The authors' experience with building association accounts has convinced them of the extreme importance of making the audit thereof in considerable detail; of carefully verifying every amount received in redemption of mortgages or paid out to investing stockholders; of comparing *every* pass book with the ledgers, and both with the lists of balances; and of testing the latter at considerable length in respect of the calculation of interest. The income received from properties on hand must be verified in every possible way; and, where such income does not seem to be a fair return upon the book-value of the various properties, the latter should be either revised or supported by independent valuation.

The papers relating to all mortgages, and the securities relating to whatever other investments there may be, must also be examined by the auditor, who will do well, in addition, to require the attorney to certify that such papers are all in order.

In the case of a building association of any pretensions, the number of deeds and mortgage papers that call for inspection will be very considerable, and accordingly a method of saving unnecessary labor will be found acceptable. In all well-managed concerns it will be found that the papers relating to each separate mortgage are enclosed in a separate envelope, upon the outside of which is endorsed a résumé of its contents. If this endorsement has once been verified and the envelope has been sealed, it is thought that under normal circumstances no similarly detailed verification of the contents is necessary at subsequent audits. At each subsequent audit all fresh sets of papers must, of course, be verified in detail, as must also the contents of those envelopes which for one reason or another have been opened during the current period, and upon which, therefore, the auditor's seal is not intact; but it is thought that where the seal remains intact, and where a sufficiently distinctive seal has been employed, any further detailed investigation is unnecessary. It should be sufficient for practical purposes to verify the contents of a few envelopes, taken at random, and also of course the contents of all envelopes

which in the opinion of the auditor may by any possibility have been tampered with.

The annual statement, printed copies of which are usually distributed among the stockholders, should be carefully verified. Some associations include in this statement a schedule of the account numbers and amounts of dues and interest either in arrears or paid in advance. This is an excellent plan and should be in general use.

The basis on which profits are apportioned among the different series of stock should also receive attention. Various plans are employed, some of which are clearly misleading. E. g., by one plan the percentage of profit earned during the year is calculated on the paid in dues only, ignoring the profits earned during previous years on unmatured series and employed as part of the association's capital during the current year.

This method results in showing a much larger earning rate than is actually the case. An investigation of the accounts of associations which claim to be earning seven and eight per cent., or even more, per annum usually discloses the fact that the percentage of profits is calculated on the basis mentioned above and the actual rate per annum is considerably less. Of course, if the association by-laws distinctly provide for such a basis of apportionment, the auditor can do nothing, but if the basis is not clearly defined in the by-laws the auditor should urge the adoption of a plan which is both accurate and equitable.

It is more than probable that the fees attaching to his office will afford the auditor no adequate remuneration for an examination conducted on such lines as those laid down; but, be this as it may, the auditor who—under ordinary circumstances—omits any of the precautions named would be worse than foolish.

It must also be remembered that there is usually a statutory limit to the borrowing powers of a society, which must not be exceeded.

X. PROFESSIONAL ACCOUNTS.

(*a*) LAWYERS.—It is not easy to effectively audit the accounts of lawyers without devoting considerably more time to the task than clients would be willing to pay for, and nothing short of a continuous audit appears to meet the necessities of the case.

Almost all lawyers use the stock forms of books sold by law stationers, and these are designed rather to save time than for any other purpose, and as framed it is difficult to audit them.

The amount included in the balance sheet for outstanding charges should, in general, be verified by comparison with the draft bills of costs. Agents' accounts should, at all times, be carefully considered, and it is not a bad plan to compare every item of costs charged up with the copy of the bill rendered, the object being to make sure that the full amount chargeable has been debited, for the amount asked for may not (by reason of an amount having been received on—or in—account) be always the amount that has to be debited.

Of recent years the increasing number of fraudulent failures and defalcations on the part of lawyers has drawn attention to the importance of proper accounts being kept by those who wish to avoid any possible reflection upon their manner of dealing with the moneys entrusted to them by their clients. It is impossible to overstate the importance of keeping clients' money entirely distinct from the moneys of the practitioner himself, while it may be added that in many respects it materially simplifies the keeping of the accounts. Each large estate should have its own separate bank account and separate books, entirely independent of the books of the firm, while all other moneys received in trust for clients should be paid into a "Clients' Account," and a separate column provided in the cash book for keeping this account distinct from the "general" bank account. Not the least important advantage of keeping

the accounts of large estates quite separate from the general accounts is that the cost of keeping them, and of having them audited, may then frequently be charged against the estate in addition to other costs. Moreover, these accounts can be submitted to the clients (or their agents) for audit without disclosing any other transaction; and if they be so audited at regular intervals, it is frequently unnecessary for them to be also audited by the lawyers' auditors, and by this means a further saving of expenses may be effected.

(*b*) ARCHITECTS.—The accounts of architects are, perhaps, not frequently the subject of professional audit, but this is a state of affairs which is always undesirable, and particularly so in cases where two or more architects are practising in partnership.

The accounts do not, as a rule, involve a particularly voluminous record, and it is therefore desirable that in all cases the audit should be a detailed one. The fact that architects are frequently not business men makes it important that the auditor should take every precaution to guard his client from loss, both through actual fraud and bad bookkeeping; it is therefore important for him to see that every item in the cash book is properly vouched, and, so far as possible, that all fees and commissions are duly accounted for. It may be mentioned here that, with regard to fees payable to an architect for supervising the erection of buildings, these fees are, as a rule, payable by way of a commission upon the value of the work done, as certified by the architect for the purpose of assessing the payments to be made on account to the builder. There will always, at balancing time, be a considerable amount of accruing fees, which, although not actually due for payment at the time, constitutes an asset; a schedule of these items should be prepared and certified by the principals for inclusion in the accounts. Many practitioners, however, work their accounts exclusively upon a cash basis, and the plan has much to recommend it when professions are concerned.

In all important undertakings in England, a "Clerk of the Works" is appointed to be on the spot, for the purpose of checking the material and workmanship employed by the builder. The clerk of the works is not infrequently appointed by the architect, but he is invariably paid by—and is the servant of—the architect's client; if, therefore, for reasons of convenience, his salary has been paid by the architect, it is important to see that it is subsequently recovered by him. This practice is not generally followed in the United States, but it has much to commend it, and in some respects, at least, the plan will no doubt be adopted here ultimately.

(*c*) MEDICAL MEN.—There are so many different systems of bookkeeping employed by medical men that it is difficult to afford any useful hints as to the method of audit in the space here available. It may be pointed out, however, that it is not, as a rule, either necessary or expedient for the auditor to go behind the debits in the patients' ledger, which, as often as not, are fixed at round sums by the practitioner without any strict reference to the number of visits. It is desirable, however, that the auditor should see that some efficient system of recording visits is in force, so that his client has all the facts before him when assessing the amount of his charges. The auditor should carefully check the credit side of the patients' ledger, noting in particular any allowances that have been made, and he should see that all cash credited to patients has been properly accounted for.

Where payments have been made on account of patients, whether for medicines, or for consultation fees, &c., it is very important that the auditor should see that they are properly charged up and collected in due course. Many practitioners employ one or more assistants, or dispensers, who are authorized to receive money, and where this is the case it is especially important that the system in use should, as far as possible, follow the ordinary commercial precautions against fraud. With those practitioners who supply their patients with medicines, it is also necessary that the accounts of druggists, &c.,

should be carefully checked, and an allowance will have to be made at balancing time for the value of drugs in stock.

It need hardly be added that where horses and carriages or automobiles are the property of the practitioner, an adequate allowance must be made for depreciation, at the rate of fifteen to thirty per cent. per annum. Where, however, these are rented it is equally important to see that the cost of hire to the date of balancing is included; or, if this has been paid in advance, that a proportionate part is held over as an asset.

In concluding this portion of the work, the authors cannot but feel that in spite of the very considerable space that has been devoted to the consideration of the special features attaching to the audit of different classes of accounts, the subject has been only very imperfectly dealt with. When, however, it is remembered that an exhaustive treatise upon the audit of any one class of accounts might easily approach the dimensions of the whole of the present work, it is hoped tht it will be conceded that—however desirable it might have been to have considered the various questions involved at further detail—more could not have been reasonably expected within the limits of this volume.

CHAPTER VI.

FROM TRIAL BALANCE TO BALANCE SHEET.

That which forms the most important part of every audit, namely, the questions of principle involved in the preparation and certification of the balance sheet and trading and profit and loss accounts from the trial balance, will now be considered. It is especially desirable that in every audit the principal should give these subjects his personal consideration, not merely because of their intrinsic importance, but also from questions of policy which have already been dwelt upon.

As the points now about to be discussed are the most important, so are they also the most debatable, accountants of the highest repute being by no means agreed as to several of the principles involved. On the other hand, it would seem to the acute observer that much of this apparent difference is, in reality, merely verbal, while perhaps more is due to the inherent difficulty that exists in casting abstract principles into a concrete form. It is, indeed, not unreasonable to suppose that, in any particular case which might be named, there would not exist among our leading practitioners any radical difference of opinion as to what the profit of a company had really been; the real cause of the confusion appearing to be that, while one maintains the true net profit to be deducible from the profit and loss account, another maintains that the balance sheet is the only reliable basis. It would seem that, if both balance sheet and profit and loss account be correct, it matters but little which is called the cause and which the effect.

Throughout the course of this chapter the endeavor will be to view the various questions of principle from the broadest possible standpoint. It is true that, by this means, the inherent difficulty of the considerations involved will not be escaped; but it is hoped that at least the treatment will be found free from catchwords and all other sources of superfluous mystification.

PRINCIPLE IN VALUATION OF ASSETS.

It being the primary object of most ordinary undertakings to continue to carry on operations, it is but fair that the assets enumerated in a balance sheet be valued with that end in view.

Taking first the case of private traders, whether *sole* or firms, it is not difficult to see that, inasmuch as no man can reasonably hope to live forever, the business of such an one is ephemeral as compared with that of a corporation. It is true that the business may, and frequently does, live longer than its founder; but to do so involves a change of proprietorship, and with it a *re-valuation of assets.* It will thus be seen that, although there is no necessity to consider the contingency of liquidation (at what are expressively known as "knock-down" prices), not merely the contingency but also the eventual certainty of a re-valuation must be faced. The basis of such a valuation will be that known as "a going concern," and it will, perhaps, be worth while to consider the meaning of this phrase. So far as it possesses any definite meaning—for, of necessity, the term is an elastic one—the qualification implies "at such a value as they would stand in the books if proper depreciation had been provided for"—the term "depreciation" being taken to represent the amount by which the value of an asset has become reduced by effluxion of time or wear. A fluctuation in value caused by external circumstances will, however, also require to be taken into consideration when property changes hands. It is important to remember that it is not really practicable to so maintain the efficiency of assets that no depreciation shall ever occur.

The accounts of incorporated companies next claim attention. These companies, having a perpetual succession, are, perhaps, entitled to be considered theoretically permanent (although, in practice, they are often much shorter-lived than private enterprises).

In the case of a corporation, however, it must be borne in mind that, whereas a private firm is under no obligation to retain the whole of its undertakings intact, the laws of our various States do not allow dividends to be paid out of capital, and this, of course, directly affects the question of permanency. It is also of more importance in the case of corporations to distinguish between what are and what are not fixed assets.

This is a point upon which even accountants might not always be agreed, while the recent statement of an English judge, that blast furnaces owned by a smelting company must be regarded as part of its current assets, emphasizes the importance of a system of accounts which may be as independent as possible of any necessity of definitely distinguishing between fixed assets and current assets. Incidentally it may be mentioned that the terms most commonly used by lawyers, "fixed capital" and "floating (or circulating) capital," are clearly incorrect. The capital of a company is that which has been contributed for the purpose of enabling it to carry out the "objects" for which it was formed: it may be possible to say what assets have been acquired with that capital, but even then the assets and the capital are clearly separate entities.

Then, too, the profit and loss account must obviously be framed so as to show the divisible profits, and the question thus remains to be considered how profits and losses that do *not* affect revenue—or, to put it another way, capitalized appreciations and depreciations—are to be treated. As a matter of bookkeeping, it is clear that two courses are open. Either the capitalized items must be disregarded in the balance sheet by mis-stating the value of an asset or a liability, or some account must be raised to record the profit or loss that is not taken

to revenue. If the latter course be adopted, the accounts should be sufficiently clear to explain what has been done: in the former case, if the assets are over-stated it is also necessary that mention should be made of the fact, as the assets appearing in the balance sheet are *prima facie* assumed to be stated at a reasonable valuation. If, however, a profit has been made which is not available for distribution, it is often considered unnecessary to modify the accounts so as to disclose the circumstance. This point, however, will be discussed more fully under the heading of SECRET RESERVES. As a rule, the amount at which *all* assets are stated in the balance sheet should be regulated—at all events to some extent—by the value of such assets.

In practice, assets may generally be divided into two classes: (1) Those *with* which business is carried on, and (2) those *in* which business is carried on; the former may be named fixed assets, the latter current assets.

VALUATION OF FIXED ASSETS.

The points to be borne in mind here are that wasting may reduce their value, and that fluctuation may increase or reduce their value. So far as wasting is concerned, inasmuch as it has directly contributed to the profit earned, it is clearly an expense with which profit may be fairly charged. The only question is "How?" which will be considered in full under the head of DEPRECIATION. On the other hand, fluctuation is something altogether apart from trading profit and loss, being merely the accidental variation (owing to external causes) in the value of certain property owned, but not traded in: to carry the amount of such variation to profit and loss account would be to disturb and obscure the results of actual trading, and so render comparison difficult, if not impossible. Moreover, as has already been stated, the profit and loss account should be so framed as to show a balance which actually exists and is legally available for dividends. On no account, therefore, should the results of fluctuations affect the profit and loss account.

Whether or not it is desirable that such fluctuations should be revealed by the accounts *at all* will be fully considered under the head of SECRET RESERVES.

It follows that the usual rule for stating the values of fixed assets in the balance sheet would be: Cost, less such an amount as is chargeable to profit and loss for accrued depreciation or exhaustion due to the operations of the business for which they have been used.

The actual cost of acquiring fixed assets (*e. g.*, stamps, conveyances, miscellaneous fees, &c.) is usually capitalized. This is not unreasonable, as such expenses are clearly an integral part of the cost price of such assets.

VALUATION OF CURRENT ASSETS.

It being the essential feature of these assets that the whole aim of the undertaking is to convert—or be able to convert—them into cash at the earliest possible opportunity, the element of immediate realization is an important factor in their value. The only point to remember is that, while a manufacturing profit is earned only when the manufacture is completed, a trading profit is only made when the sale is effected. Neither profit must be anticipated, but it does not appear to be invariably essential that manufacturing profit should be held over until a sale has been effected. It may be added that, where a manufacture consists of several distinct processes, and separate accounts are kept of the manufacturing profit earned under each process, there seems to be no great objection to each process being considered as a separate manufacture, so long, of course, as the goods are readily saleable at the usual trading price.

It must not be lost sight of, however, that these are book profits only, and in this connection it is well to bear in mind the decision in the American Malting case (see Appendix C), where the court said: "To calculate months in advance on the result of the future transactions, and on such calculations to

declare dividends, was to base such dividends on paper profits —hoped for profits, future profits—and not upon the surplus or net profits required by law."

With regard to what is a trading profit, a most ingenious argument was once advanced by counsel who subsequently became Lord Chief Justice of England, who contended that the most scientifically correct method of valuing a stock-in-trade was to take it at selling prices, less the average trade profit; it being suggested that any profit realized in excess of the average was in reality a profit on buying, not on selling; and any profit realized less than the average, a corresponding loss on buying. The argument passed muster at the time, appears to be plausible, and indicates a system that would doubtless prove very convenient in practice; but, unless the profit on different articles was very uniform, it would hardly be a safe one to adopt.

RESPONSIBILITY FOR VALUES.

A much-debated point is the extent of responsibility incurred by the auditor in relation to the values set upon the assets of a company in the published accounts of the directors. The opinion arrived at in the English Court of Appeal in *The London and General Bank* case upon this most important point appears to be that the auditor incurs no responsibility whatever so long as, after exercising reasonable care and diligence, he has honestly arrived at the opinion that the accounts are correct. It will be seen, however, that this decision in no way commits itself to the expression of any particular opinion as to the mode of valuation to be adopted. In this latter respect it is interesting to note a recommendation by a Committee of the English Board of Trade that the balance sheet of every company shall show (*inter alia*) "whether the assets are taken at cost price, or by valuation, or on what other basis they are stated, and whether any, and if so what, amount or percentage, has been written off, and what other provision, if

any, has been made for depreciation." This recommendation is a very excellent practice to follow, and has for many years past been adopted by some leading accountants.

The question of auditorial responsibility is fully considered in Chapter X.

VERIFYING EXISTENCE OF ASSETS.

Having settled a basis of valuation, the next thing would appear to be to obtain evidence of the existence of the assets enumerated in the balance sheet.

The evidence necessary in each class of assets would be as follows:—

LAND AND BUILDINGS.—The title deeds of the property should be and sometimes are sufficient evidence, but it is to be regretted that title deeds are not always delivered in real estate transfers. Where there is any doubt upon this point the official county records should be consulted. Should the property be mortgaged the title deeds may possibly be in the possession of the mortgagee (although this practice does not, so far as is known, exist in the United States), and in such a case an acknowledgment of this fact should be obtained from him or his attorney, together with a statement of the amount due. Conversely, the verification of an asset represented by a mortgage would be the production of the title deeds and the mortgage papers. In the case of a second mortgage, the title deeds may, as stated above, be in the custody of the first mortgagee, and here the auditor will require to satisfy himself that such first mortgagee has received proper notice of the existence of a second charge.

STOCK-IN-TRADE.—The original stock sheets, signed by the stock-taker, calculator, checker, and manager. Most accountants would, in addition, consider it essential that the extensions and additions be re-checked by one of their own

staff, and, further, require to be satisfied as to the soundness of the principle of valuation adopted.

The auditor's liability in connection with the valuation placed in the accounts upon the amount of stock-in-trade has been considered in several English cases, which are more fully dealt with in Chapter X. It may be pointed out at this stage, however, that the general effect of these decisions seems to be that, where the circumstances of the case are not such as to arouse the suspicions of an ordinarily capable and diligent auditor, he is justified in relying upon the valuation of stock-in-trade which has been submitted to him and certified to him by the manager. It is altogether likely that American decisions will follow this general rule. In one English case, the auditors took the precaution to state in their certificate that they accepted no responsibility for the valuation of the stock "which had been certified to them by the managing director," and as a matter of prudence it would no doubt be as well for the auditors to always add this qualification. It may be added, however, that such a qualification as this would certainly not appear to save the auditor, where he had reasonable grounds for doubting the valuation itself; whenever his suspicions have been aroused, it is absolutely necessary that the auditor should sift the matter to the bottom.

INVESTMENTS IN STOCKS AND BONDS.—The auditor will require to have produced to him the scrip, certificate, bond, or other document, proving that the ownership of the investment in question is vested in his clients; and he should also require production of the broker's bill, with a view to verifying the cost price thereof.

In the case of securities deposited under reorganization plans, &c., it becomes necessary to secure a certificate that, upon the date of the accounts, such stock or bonds stood registered in the names of the auditor's clients. Of course, if a negotiable receipt has been given, the receipt itself must be produced, but if it is a mere memorandum receipt, the date

must be carefully noted, as it may be that in the event of a subsequent sale it does not have to be surrendered.

Funds deposited as security should be verified by an independent confirmation addressed to the auditor.

Investments on behalf of a company sometimes stand in the names of individuals, who hold them in trust for the company. A proper declaration of trust, duly executed, should in all cases be produced to the auditor.

It may be added that if, when examined, the securities are securely sealed up in packages, it is not necessary at subsequent audits to re-examine them in detail, if the seals remain unbroken.

BOOK DEBTS.—The extent to which it is practicable to verify the existence of book debts depends largely upon circumstances. Unless they are very numerous, the auditor should satisfy himself that the total appearing in the balance sheet agrees with the ledger balances, and that proper provision has been made for cash discounts and bad debts. With regard to the discounts, it is customary to deduct the full cash discount upon all ledger balances. It is questionable whether this is really necessary, although it is clearly a prudent course to adopt; but where cash discounts are deducted from the trade creditors they must, of course, be also deducted from the trade debtors. With regard to bad debts, the auditor should obtain a certificate of at least one responsible person acquainted with the facts, to the effect that in his judgment due provision has been made for any loss that is reasonably likely to occur. It is naturally impossible for the auditor to verify this provision in detail, but he can at least take note of overdue and "dead" accounts, and see whether such provision as appears to *him* to be adequate has been made in respect of these. As the number of book debts increases it becomes impracticable for the auditor to verify the ledger balances in detail; it has already been explained, however, that, where an

adequate system of internal check exists, the verification of details can to a large extent be superseded by tests. For all practical purposes it is probably as efficacious to check the balances of, say, one or two ledgers out of twenty as it would be to check the whole.

PLANT, MACHINERY, FIXTURES, &c.—There is, perhaps, too much tendency to assume the correctness of the "book" figures with regard to these assets, provided reasonable provision has been made for depreciation: it is important, however, to make careful inquiries into all additions, with a view to seeing that they represent *bona fide* capital expenditure that may properly be added to the value of the asset, and, further, to make particular inquiry as to the sale of worn-out or discarded assets. It not infrequently happens that such sales are erroneously credited to sales account, with the result that the latter is overstated, and that due inquiry into the *loss* in respect of such sales is overlooked. The amount realized on the sale of fixed assets should, of course, be credited to the real account standing in the books in respect of this asset; but the realization affords an opportunity of inquiring into the value at which these assets stood in the books, and should they have been sold at a loss, that loss must in all cases be written off, as otherwise an item will be brought into the balance sheet as an asset which represents assets no longer in existence.

Occasionally, as has already been stated, a re-valuation will be made for the purpose of assessing, or of checking, the provision for depreciation; but in any case a certificate should be forthcoming, to the effect that the various items included in the last inventory are still the property of the undertaking.

BANK BALANCE.—Bank pass book verified either by personal visit to bank or by banker's certificate of balance.

In practice it will rarely happen that the balance recorded in the pass book exactly agrees with the balance in the stub,

and a Reconciliation Account has therefore to be prepared upon the following lines:—

Balance as per stub		$6,033.08
Add, Cheques unpaid, viz.:—		
Dec. 16, Jones	$140.20	
" 21, Smith	89.29	
" 29, Brown	362.12	591.61
		$6,624.69
Less, Deposits, not credited, viz.:—		
Dec. 30, Collection	$600.00	
" 31, Sundries	212.50	812.50
Balance as per pass book, Dec. 29		$5,812.19

Where practicable it is desirable that the auditor should see that the various adjustments which constitute the difference between the pass book balance and the cash book balance are rectified in due course by subsequent entries in the pass book.

CASH IN HAND.—Verified by production of actual cash balance, or, if the date of the accounts has gone by, by exhaustively verifying the bank account up to date of audit and *then* counting the balance of cash in hand. In cases where there is more than one cash drawer, all must be produced to the auditor and verified by him simultaneously; and, wherever practicable, it is preferable that all cash in hand should be paid into the bank on the afternoon of the date of the balance sheet, in which case, of course, no occasion arises for the auditor to verify the balance of cash in hand, for the all-sufficient reason that there is none. In the case of cash at distant branches, a satisfactory certificate that the balance exists may generally be accepted in lieu of actual counting. In continuous audits all cash balances should be frequently verified, say, at least once a month.

Whatever may be said in general terms, however, as to the desirability of an auditor verifying balances of cash in hand, it is clear that it would be only prudent to regard the existence

of a large floating balance as *prima facie* a matter for suspicion, and therefore a matter calling for careful inquiry.

BILLS RECEIVABLE.—Verified by production of the actual notes themselves. Care should be taken to see that no overdue notes are included in a balance sheet under the heading of "Bills Receivable"; that due provision is made for discount where necessary; and that all anticipated loss by way of bad debts in respect of bills receivable—both in hand and under discount—is included in the accounts.

WORK IN PROGRESS.—This should be certified by the factory manager, the chief cost clerk and the manager. In the case of readily saleable goods manufactured in quantities, the usual rule is to value work in progress at cost—the term "cost" being defined as the cost shown by the cost accounts, which, as a rule, includes of course, a certain amount of "loading" for factory and overhead expenses. When the work of any one manufacturing department has been completed, there seems no reason why that department should not be entitled to take full credit for the entire cost of the work performed, and in such case care must be taken to see that the stock of unfinished goods represents items that will be finished and sold at the normal rate in due course.

When work in progress consists of single articles—as, for example, in the case of contract work—its valuation becomes both a more difficult and a more serious matter, partly because past experience is no longer available as a guide and partly on account of the magnitude of the figures involved. In the case of contracts extending over a number of years, it is clear that annual accounts can only approximately estimate the true net profit earned in each year. In the case of manufacturing firms it is for the partners to mutually agree on a basis for the valuation of work in progress, but the safest course would appear to be not to take credit for any profit on uncompleted work. In the case of companies, however, which require to produce annual accounts, and to pay annual dividends, this course is hardly practicable. A company is not obliged to

wait until profits have been actually realized in cash before crediting anything to revenue. There is, therefore no illegality in taking credit for estimated profit on work in progress; but, in view of the extreme difficulty of arriving at an accurate estimate, and the extreme uncertainty that often prevails as to what the ultimate result will be, it is clear that only very conservative estimates can be safely indulged in. Here, again, the principle laid down in the American Malting case should be emphasized, and care taken to keep within the rule that dividends must not be paid out of anticipated profits. Cost accounts should, of course, in all cases be available to show the actual cost of each contract up to the date of the accounts. If the work has so far proceeded that it is possible for the Manager to certify an outside figure, that will not be exceeded, for the cost of completing the work, it would not be unreasonable to apportion the profit between the two periods according to the expenditure incurred in each, providing, of course, ample reserves in all doubtful cases. In connection with work less far advanced it seems more questionable whether anything in excess of manufacturing cost can be safely treated as an asset. In this connection, however, it may be borne in mind that all large contracts are readily capable of division into sections, the cost of each of which has already been estimated in advance. A comparison of the cost accounts in respect of the work performed with the original estimates will thus enable a fairly reliable view to be obtained of the general position of the contract, more especially, of course, in those cases where the speculative part of the work is in the earlier stages.

In the majority of cases, where contracts extend over a lengthy period, it is usual for payments to be made on account, upon the certificate of the architect, or engineer, as the case may be. The amount of such payments would be from seventy-five per cent. to ninety per cent. of the value of the work actually performed, and it is clear, therefore, that the excess of money received over expenditure incurred may safely be regarded as the minimum profit earned up to date.

SALES FOR FUTURE DELIVERY.

The question has arisen more than once as to whether a company is entitled to take credit for profit expected to be earned in respect of orders booked for future delivery. The point is naturally one of considerable importance in some industries, as, for example, with automobile dealers, who frequently book orders for future delivery, and also with regard to coal merchants, cotton merchants, and the like, who enter into contracts to supply their goods for some time in advance. The general rule which has been laid down in this work is, it is thought, unquestionably the safe one to in all cases adhere to, namely, that the profit on the sale of goods should be taken credit for at the time when the sale actually occurs; and where it is an essential portion of the contract of sale that the goods shall not be delivered until some future date, then the actual *sale* would certainly appear to be at the date of delivery, and not at the date of booking the order. Like many other matters, however, this is, perhaps, as much a matter of degree as a question of principle, and where orders have been actually booked so that a valid contract exists upon which the customer could be sued for payment, the mere fact that the goods have not been delivered might well be overlooked and the profit taken credit for in the period when the order was booked; this, however, could certainly only be applied where the goods were actually in stock, and not when they were still unmade. Even where it is decided that credit may reasonably be taken for such future sales, it is important to remember that when payment is delayed a reasonable rebate should be made for loss of interest, and under no circumstances could any harm be done by postponing the whole of the profit until the period when the goods were actually delivered.

The American Malting decision has been handed down since the above was written, and in view of the opinions there expressed it may be assumed that, from a legal point of view, considerable risk is taken whenever anticipated profits are carried into the books.

OUTSTANDING ASSETS.

The point that now claims attention is the question as to how far it is the auditor's duty to consider the propriety of including certain items among the assets that relate to transactions which at the date of the balance sheet are uncompleted.

It has been said that no profits should be taken into account that have not been actually received in cash, unless there is every reasonable likelihood that they will eventually be so received. This, of course, means that a sufficient provision must always be made for bad and doubtful debts, but it means something else besides. With some classes of transactions it is quite possible—even though the transactions themselves are not actually completed—to say with reasonable certainty what profit will eventually result; and, in these cases, it would appear that the most correct course would be to apportion the profit so that each period took credit for the profit arising from its portion of the transaction. Thus, in the absence of evidence that would lead one to a contrary supposition, the profit arising from sales may safely be credited to the period in which the sales occur, and the profit arising from manufacture similarly belongs to the period in which the articles are manufactured. The income arising from first-class investments (*e. g.,* interest on government or railway bonds, or interest on mortgages, or rents) may likewise be said to accumulate from day to day. With regard to the latter, however, the question of convenience intervenes; and, unless the amount involved is of sufficient magnitude to render absolute accuracy desirable, it would probably be considered sufficient if only those sums actually due were considered as assets—the amount accruing being taken as a set-off against liabilities of a similar nature. Turning now to another class of transactions, the final result of which can only be approximately determined, no accruing profit can, with safety, be taken credit for upon the uncompleted voyages of ships, or uncompleted contracts (except so far as previously indicated), nor for accruing dividends other than on guar-

anteed stock, nor (under normal circumstances) for uncompleted consignments; the eventual result of all these transactions being generally of so speculative a nature that it is not safe to do more than carry forward whatever expenses may have been incurred.

Sometimes, for the purpose of providing a secret reserve, assets are intentionally understated; except when done advisedly, however, there is but little fear of the auditor finding the assets understated. Occasionally defalcations have, by this means, been made to fall upon revenue (generally by writing off good debts as bad), but the attention thereby attracted to the existence of a leakage prevents such a course from being at all common.

OUTSTANDING LIABILITIES.

For a similar reason, there is but little fear of liabilities being overstated; how far it is necessary for the auditor to take special steps to guard against their under-statement is the matter that now claims attention. While the practice of "dating-forward" invoices is so common, there will always be some danger of goods being included in stock without having been passed to the credit of the purchase ledger. "Stock-taking" statements might help to discover the omission, but they also might not. It will be a great help, therefore, if the services of the stock-keeper are requisitioned, and he be made responsible for the production of invoices for all goods that have passed through his hands. The purchases for the next few weeks after the date of balancing may also be usefully scrutinized.

All expense accounts (*e. g.*, wages, salaries, &c.) should be carefully examined, to make sure—as far as possible—that no outstanding liabilities have been omitted.

It is a common practice to set off accruing rent, interest, &c., against insurance, taxes, and other items paid in advance, and to keep a fixed sum suspended to meet whatever difference

there may be. The plan certainly possesses the advantage of convenience, combined with practical accuracy; but the sufficiency of the fixed sum should be verified at every audit, as the circumstances may easily vary from time to time.

The auditor's own fee is a matter in which he will naturally be interested. There is no uniform practice, however, some preferring to debit the accounts of the period under audit with the fee, and some the period in which the audit is conducted. The latter course is naturally the most convenient where the amount chargeable depends upon the time occupied, but the former method is probably the more correct.

The minute book may, and frequently does, disclose the existence of liabilities—both certain and contingent—that are not recorded in the books of account, and an audit cannot be called complete unless this book is carefully scanned. A case in point occurred in connection with the audit of a street railway company where the minutes stated that the President was to receive his salary in common stock at par. As a matter of fact, he had been drawing it in cash, but as the stock was worth only a few dollars a share the variation made a material difference to the company.

CONTINGENT LIABILITIES must not be forgotten. Bills discounted are, perhaps, the most usual source of contingent liability; a reserve therefor rarely appears in a balance sheet, however, although frequent losses occur through the failure of makers to pay their notes. The auditor should, therefore, scrutinize the notes under discount, and particular attention should be paid to those which have been renewed one or more times without any reduction being made in the amount. Disputed claims must not be lost sight of; and claims for dilapidations upon premises, the lease of which has almost expired, should be anticipated, so that the whole loss may not fall upon one year.

It is sometimes claimed that arrears of cumulative preferred dividends also come under this heading, but this can hardly

be admitted. Such dividends are under no circumstances a liability—definite or contingent—until declared, and any arrears are only of interest as to future distributions of profits between preferred and common stockholders. Hence, a simple foot note on the balance sheet of the amount in arrears would cover the case.

HIRE-PURCHASE AGREEMENTS.

This subject is of sufficient importance to merit a separate heading. Detailed treatment of the subject may be found in the author's "Advanced Accounting," which deals fully with those advanced problems that are questions of account, as such, rather than questions of auditing.

From the auditor's point of view, the main point of importance is to see that a correct system of dealing with the transactions is adopted which charges a sufficient proportion of the instalments against the revenue of each year, so as to avoid the proportion which is being capitalized appearing at too high a figure.

There is some difference of opinion as to the proper method of treating railroad car trust bonds which represent a species of hire-purchase agreement. One opinion is that entries pertaining to car trusts need only be made in the books of the lessee-purchaser as payments provided for in the agreement are made, and consequently no liability need be shown in the balance sheet for the instalments not yet due. As a matter of fact this course is followed by some of the largest railroads in the United States. The President's report of one of them for 1908 shows that at December 31 of that year the Company had outstanding for account of itself and its sub-companies car-trust certificates aggregating some $61,000,000.00, which, with the exception of a comparatively small amount (presumably the proportion of the next instalment accrued to December 31) do not appear in the balance sheet at all.

It is submitted that this is a very unsatisfactory method of treating such transactions. Certainly these car-trust certificates are just as real a liability as any of the mortgage bonds, and usually they run for much shorter periods. It may be contended that the equipment, which is the subject of these certificates, is not the property of the railroad company and will not be until fully paid for, and hence it would not be proper to include it among the assets of the company. This objection is hardly a logical one, as it would be just as valid against including assets which are specifically pledged, or conveyed in trust, to secure an issue of mortgage bonds, and it is hardly thought that any one would argue for excluding mortgage bonds and the property securing the same from the balance sheet. The best method of treating such obligations from an accounting standpoint is to enter them as a liability when contracted, the equipment covered thereby being treated as an asset; if it is desired, a separate account can be kept for such equipment as well as showing it separately in the balance sheet.

Cases frequently occur in which furniture, musical instruments, books, &c., are sold under hire-purchase agreements, and in these cases the rate of interest charged is almost invariably high, usually varying from ten per cent. to thirty per cent. per annum on the unpaid instalments. For present purposes it will be sufficient to point out that firms transacting business of this description in the nature of things deal with a very large number of items, each of comparatively small amount. It consequently follows (1) that it is impracticable to keep such intricate accounts as would be necessary to accurately apportion every instalment received between interest and capital; (2) that such scrupulous exactness is unnecessary in practice, as the volume of the transactions is sufficient to enable an *average* to produce fairly reliable results. The best principle, therefore, is to regard the difference between the cash price and the credit price of the articles sold as interest charged, and having ascertained the average rate of interest to apportion it between the years over which the currency of

these agreements runs. By this means practically accurate results can be obtained with a very small expenditure of labor. The apportionment should, however, be in favor of the later years, so as to err upon the side of caution, and it may be added that the provision for bad debts will here require special consideration.

DEPRECIATION.

This is a question of the utmost importance, and it is therefore desirable that the matter should be considered in detail. Before doing so, however, it may be well to remind the reader of the distinction between depreciation and fluctuation. Depreciation is a shrinkage in value which, in the ordinary course of events, may be expected to take place, as being a necessary consequence of the possession and use of the asset; it consequently is a charge against revenue. Fluctuation, on the other hand, arises from causes entirely outside the scope of the business, and may affect the value of its assets either adversely or favorably. The operations of fluctuation cannot, however, affect true trading profits either one way or the other, and, as a rule, therefore, it is best to disregard it in the accounts. A favorable fluctuation in the value of fixed assets seems the proper subject for a secret reserve. A favorable fluctuation in current assets is temporarily a secret reserve, which will be included in the trading profits when those assets are realized. An unfavorable fluctuation in current assets may be disregarded so long as there is every reason to believe that it is of a temporary character, but if it seems likely that conditions will remain unfavorable until the time comes for realizing those assets, then the loss should be anticipated; or, to speak more accurately, it should be charged against the period in which it actually occurred, rather than against the period in which it was realized. An unfavorable fluctuation in fixed assets need not, under normal circumstances, be charged against revenue before declaring dividends out of current profits. It may therefore, be disregarded in the accounts; but, in order that the true position of affairs may be placed before the stock-

holders, it is desirable that either a note should be appended to the balance sheet, drawing attention to the shrinkage in value, or a paragraph to that effect be inserted in the auditor's report.

In connection with this distinction between depreciation and fluctuation it should be added that in some quarters the practice has been strongly advocated of occasionally having fixed assets re-valued as a check upon the annual provision for depreciation, and appraisal companies which make a specialty of valuations, particularly for the purpose of testing the adequacy of insurance carried, have met with considerable success in recent years. There is much to be said in favor of re-valuations, in that it is always desirable to take every reasonable opportunity of testing the sufficiency of estimated provisions; but, on the other hand, it must be borne in mind that a re-valuation can hardly fail to take into consideration fluctuation as well as depreciation, and consequently may introduce into the accounts a disturbing element, obscuring the real result of the trading. It ought not, however, to be impossible to check the provision made for depreciation by means of re-valuation without introducing these complications.

In order to make it quite clear what is intended, it may be pointed out that a machine costing (say) $500, and a further $100 to repair, may answer its purpose for (say) six years, and then have to be sold as second-hand for $75. This leaves a cost of $525 to be written off over the six years' life. Under the circumstances it might be reasonable to charge this at the rate of $87.50 per annum (equals 14½ per cent.), or the efficiency of the machine may be so high when new that the reasonable procedure would be to charge 27½ per cent. on the reducing balance, which would reduce the $600 to (approximately) $75 at the end of the sixth year; but, whichever method be adopted, it is more than probable that the balance shown on the machinery account at the end of the first, second, third, fourth and fifth years would not agree with the valuation made by an expert at those times. The reason for this is that the expert would take into consideration the value of the ma-

chine in the market, whereas the manufacturer is only concerned with its value to him. Moreover, the market value may be influenced by other considerations besides the actual condition and state of newness of the article in question. The existence of new and better types is, of course, a risk that ought to be provided for by depreciation, but fluctuations in the value caused by an increase or reduction in the *cost of producing* similar machines in no way affect the cost of the original machine that has to be written off over a term of years.

COMPARATIVE TABLE.

	Reduced by 14½% on Cost	Reduced by 27½% per annum	Re-valued (say)
Cost (including Erection)	$600.00	600. 00	$600.00
Depreciation 1	87.50	165.00	200.00
" 2	512.50 87.50	435.00 119.60	400.00 75.00
" 3	425.00 87.50	315.40 86.75	325.00 75.00
" 4	337.50 87.50	228.65 62.90	250.00 50.00
" 5	250.00 87.50	165.75 45.60	200.00 50.00
" 6	162.50 87.50	120.15 33.05	150.00 75.00
Estiated Break-up Value . .	$75.00	*$87.10	$75.00

With these preliminary remarks we may proceed to the special features in connection with the depreciation of various classes of assets to be considered.

LAND may quickly be dismissed—it suffers no depreciation. Fencing, and other similar works, would, of course, depreciate, but the item would not usually be of sufficient importance to require consideration. If, however, it became a large item, it should be treated separately as plant (*q. v.*).

*The estimate is (it will be seen) too large. It is, however, no serious matter to charge the whole of the deficit—$12.10—against the sixth year's profits, increasing that charge to $45.15.

BUILDINGS depreciate to an extent varying greatly according to the quality of the workmanship and materials employed in their erection. The amount of the ledger account will frequently include land, which, as we have seen, does not depreciate; the depreciation will, therefore, be confined to the building itself. If the instalment plan be adopted, from one and one-fourth to three (or even five) per cent. of the original amount may be deducted annually; if the annuity method be used a fixed sum debited to revenue, which, after crediting interest, will write the asset down to zero in from, say, fifty to one hundred and fifty years; or, if the sinking fund system be preferred, such a sum may be set aside as will accumulate to the cost of the building in that time. In each case all repairs will have to be borne by revenue, in addition to the depreciation. With regard to the relative merits of the instalment, annuity, and sinking fund methods, the latter two are distinctly preferable; although—on account of its greater simplicity—the instalment method is frequently used for short leases. The annuity system differs from the sinking fund in that the instalments are not invested; the (net) amount of each successive instalment therefore requires to be increased to compensate for loss of interest on the previous uninvested instalments.

The student who is not familiar with the best methods of calculating annuities, &c., is referred to a very good treatise on this and other subjects, entitled "The Accountancy of Investment," by Charles E. Sprague, Ph.D., C.P.A.

GOODWILL does not "depreciate." On the other hand, it will generally be conceded that it is liable to fluctuations, both continual and extreme; as, however, no one would think of calling its omission from a balance sheet a secret reserve, it will probably be most convenient to deal with the question of goodwill under the present heading. As a matter of fact, goodwill is not written down *because* its value is supposed to have become reduced—such a course is all but unknown. The amount at which goodwill is stated in a balance sheet is

never supposed to represent either its maximum or its minimum value; no one who thought of purchasing a business would be in the least influenced by the amount at which the goodwill was stated in the accounts; in short, the amount is absolute meaningless, except as an indication of what the goodwill may have *cost* in the first instance. Inasmuch, therefore, as nobody can be deceived by its retention, there is no *necessity* for the amount of goodwill account to be written down. On the other hand, the practice is not unusual, where sufficient profits are being made. The question is not, however, one upon which the auditor is required to express an opinion; and, so long as the item is separately stated in the balance sheet, it is scarcely desirable that he should interfere with the discretion of the management, although there is, of course, no objection to his offering an opinion when he is invited to do so.

HORSES invariably depreciate, and—if heavily worked—very rapidly. The rate of depreciation will probably vary between fifteen and twenty-five per cent. on the starting balance of the account. Until experience has shown the actual rate of depreciation, it will be safer to arrive at the result by a re-valuation (which with horses can be more accurately done than with most things), and where only a small number of horses are employed (say twenty or less) the re-valuation should often be resorted to, if only as a check upon the rate of depreciation employed.

INVESTMENTS need not be depreciated unless of a wasting nature—such as shares in mines or single-ship companies. As to how far it is desirable that fluctuations in their value should be considered, the reader is referred to the paragraph on "Secret Reserves" (*postea*).

LEASEHOLD LAND AND PREMISES.—The premium paid for leases may be regarded as the purchase-money paid for a terminable annuity of the difference between the annual value of the property and the annual charges. In short-term

leases the readiest method will be to charge a proportionate part of the term against each year's revenue; but the method is too rough to be employed if the term exceeds, say, eight or ten years. In the case of longer leases the annuity, or sinking fund, plans, which were discussed under the heading "Buildings," should be adopted. Sometimes the termination of a lease finds the late lessee liable to a claim for dilapidations; this claim may amount to one year's rent, or even more, and it is therefore a convenient and prudent course to adopt to deduct about one year from the unexpired term of the lease before making the depreciation calculations. All repairs are, of course, chargeable to revenue; but they may be averaged by the temporary or permanent employment of a repairs (fund) account through which revenue is charged with a fixed amount annually, the difference between the actual expenditure and the annual charge being brought forward as a liability, or (more rarely) as an asset.

Before leaving this point it is well to bear in mind that, in the case of exceptionally long leases, or exceptionally badly built premises, it may be necessary to increase the annual charges for depreciation beyond the usual rate, so as to provide for the re-building of the structure during the lease.

MACHINERY depreciates by wear and tear, and by becoming obsolete. In addition to charging all repairs and (partial) renewals to revenue, from seven and one-half to twelve and one-half per cent. should be written off annually from reducing balances. Boilers, which depreciate more rapidly, should be reduced from ten to fifteen per cent. per annum. Loose tools are most conveniently dealt with by means of a re-valuation. It is desirable that a sound practical opinion be obtained as to the precise rate to be adopted in any particular case, and a thorough re-valuation from time to time is very desirable.

The practice of having a subsidiary ledger containing the details of the machinery account in the general ledger should

always be advocated. It greatly facilitates the labor of securing rates of depreciation, and is invaluable in case of fire, and in fact for many other purposes, such as determining the amount to be written off in the event of sales.

The rates of depreciation on machinery are discussed more frequently than any others, no doubt because they are more difficult to fix.

In this connection the following extract from an address on "Depreciation, Renewal and Replacement Accounts," by Herbert G. Stockwell, C. P. A., delivered before the annual meeting of The American Association of Public Accountants, held in Denver, October, 1909, is of interest:

"I think it can be confidently asserted that there are no two manufacturing plants in this country in which the management is sufficiently identical in character, ability and temperament that a depreciation charge in the same amount, or on the same percentage basis, could be correctly used in both. This being true, how useless it is to attempt to form averages for the life of machines in all plants, even in the same lines of business!"

All interested in the question of depreciation should read Mr. Stockwell's exhaustive and valuable paper; it may be found in the Year Book of The American Association for 1909, published by The Accountancy Publishing Co., New York.

MINES, undoubtedly, depreciate in direct proportion to the amount of mineral extracted. By a singular inconsistency of the law, however, no depreciation need be provided for by a mining company before declaring a dividend. Where depreciation is provided, the correct method appears to be to write off annually such proportion of the total cost (less residual value of plant) as the year's output bears to the estimated contents of the mine, or—in the case of a lease—such proportion of the total cost as the year's output bears to the estimated total output during the lease.

On the other hand, it must not be forgotten that there is so much uncertainty about mining ventures that it would be practically impossible, merely by the adoption of any system of accounts, to insure that the whole of the capital of the undertaking was always maintained intact; while the persons who invest in this class of concern would doubtless object to large funds accumulating in the hands of directors, and earning a low rate of interest, which might legally be distributed as dividend, even though in point of fact they constitute a return of capital. Perhaps, therefore, it is best that mines should be regarded as coming under a distinct category as "non-permanent" undertakings, the excess of current expenditure being distributed, irrespective of the value of the remaining assets as contrasted with the paid-up capital.

PLANT, other than machinery, generally runs comparatively little risk of becoming obsolete, and a deduction of from five to seven and one-half per cent. will, therefore, usually suffice. FURNITURE and FITTINGS should, however, be subjected to a somewhat higher rate. In both cases an occasional re-valuation will be desirable.

Plant (or machinery) acquired upon the hire-purchase system must, of course, be depreciated. Under normal circumstances the depreciation will be in accordance with the nature of the asset, whatever it may be. It should be borne in mind, however, that if full depreciation be charged during the currency of the agreement, in addition to the proper interest instalments, the consequence will not infrequently be to charge against the profits of the earlier years a sum in excess of what it would have cost to merely hire the articles in question. The cost of simple hire may fairly be regarded as the maximum amount that need ever be charged against profits for the use of any asset, consequently the full provision for depreciation may require to be modified during the currency of the hire-purchase agreement.

PATENTS are virtually leases of a monopoly, and although it is possible that some value—in the nature of goodwill—

may remain after the patent has run out, it seems desirable that the cost of a patent should be written off within the course of its life. Where a patent has not been purchased, but remains the property of the original patentee, it is very undesirable that the item should be treated as an asset at all, except to the extent of its actual cost in fees, &c.: such a course would seem to be every bit as artificial as a similar treatment of goodwill, which *sans dire* is a latent asset in every paying concern.

A similar mode of treatment will apply to COPYRIGHTS, except that their commercial value has usually expired long before the copyright has run out. (See further under "Publishers' Accounts.")

SHIPS undeniably depreciate, although the rate at which they do so is so variable that no general rules can be given that would prove of any practical utility. The amount of depreciation is usually certified by a competent engineer, and, therefore—so long as his report looks plausible—the auditor is relieved from undue responsibility. So long as the auditor's certificate makes it perfectly clear that no depreciation is being laid aside, and so long as the Courts see no illegality in such a course, there does not appear to be any valid objection, from an auditor's point of view, that is not outweighed by the resultant advantages.

THEATRICAL PLANT, &c.—Although there can be no reasonable doubt that theatrical scenery, "props.," and other stock-in-trade are liable to depreciation, it is probable that few accountants would care to accept the responsibility of settling the actual amount. So far as the author has been able to ascertain, the only practice in vogue is a periodical re-valuation, and it will very likely recommend itself to the auditor as being, perhaps, the safest course. COPYRIGHTS and PERFORMING RIGHTS, when not purchased upon "sharing" terms, will also require to be dealt with; but, unless there appear to be very good reasons for believing that a "revival" at no very distant date would prove remunerative, it would probably

be considered safest to regard the whole cost as a mounting expense.

REPAIRS will, in all cases, require to be charged against profit and loss; but, with a view to equalizing profits, it is a very good plan to charge a fixed sum to profit and loss, and to credit that sum to a "Reserve for Repairs Account," against which account the actual repairs will be debited. Except in very special cases, however, a debit balance on the reserve account should not be passed as an asset. If the amount expended upon repairs is below the average of previous years, it may be desirable to reconsider the value of the property itself.

LANDLORD'S FIXTURES.—In the case of plant, machinery and fittings erected upon leasehold property, it is important not to lose sight of the fact that, so far as these become landlord's fixtures, the minimum rate of depreciation permissable is one that will entirely write off the book-value by the time the lease expires. The question as to what are, and what are not, landlord's fixtures is, however, far too intricate to be usefully dealt with here.

A few years ago the author contributed a volume on "Depreciation, Reserves and Reserve Funds" to the "Accountants' Library" series (Vol. XXVI.). Numerous pamphlets, articles and lectures on this subject by leading American accountants have in addition appeared from time to time, and reference to them may readily be had.

PROVISION FOR BAD AND DOUBTFUL DEBTS.

Unless the outstanding book debts are extremely numerous, it is desirable that the auditor should go over the list in company with his client, or the manager, or some equally responsible authority, and settle the amount of loss to be provided for. Where the number of accounts renders this course impracticable, a certified list of amounts to be treated as bad, and a statement that the provision made is sufficient, signed

by the aforesaid responsible authority, should be supplied to the auditor. It is a fact that sometimes an experienced accountant will give a far more reliable valuation to book accounts than the owner or manager of a business can do. No doubt the training and experience of an accountant help him in many ways to gauge the probable realizable value of book debts; but unless his experience be confined to one particular industry (or at most to a few industries), his knowledge of the financial standing of the customers can of necessity be only fragmentary at the best. It is, moreover, thought to be undesirable for an auditor to differ from the deliberate opinion of, say, a manager, unless he is prepared to give solid reasons in support of his views. On the other hand, it is not intended to suggest that, merely because the auditor has been supplied with a certified list of the provision which it is thought necessary to make for bad and doubtful debts, all he has to do is to accept it without further comment or inquiry. It, of course, remains for the auditor to satisfy *himself* that the provision is one which appears to be both *bona fide* and reasonable. In this connection the following extract from an article which appeared in *The Accountant* will be found useful:—

"With trading concerns debtors who always take a cash discount may, in the absence of information to the contrary, always be assumed to be good for any outstanding balance not greatly in excess of their ordinary amount. Debtors who always give notes for their accounts may, under similar circumstances, be regarded as good, provided the notes are always met at maturity without renewal. Where there are renewals, the accounts should be examined more carefully; and, as the number of cases would not be large, this detailed inquiry would not be impracticable. Accounts showing an increasing debit balance require more careful scrutiny than those where the balance is reduced, more particularly if the number of transactions during the period be small. In the case of interest-bearing debts, the punctual payment of the interest may be taken as presumptive evidence that the principal is good, provided it be not in arrear; but where the interest is in arrear, the presumption is that the debt is at least doubtful, unless sufficient security is held to cover the amount. 'Dead' accounts are more likely to be doubtful or bad than 'live' accounts; and in this connection a debtor who, during the current year, has not paid enough cash to extin-

guish the balance against him at the commencement of the year, may generally be regarded as a 'dead' account, and treated accordingly. Apart from the open balances standing against the various debtors in the customers' ledgers, it is important not to lose sight of unmatured notes, whether these be in hand or have been discounted; but, as has already been stated, a customer who invariably meets his notes at maturity may usually be regarded as safe to continue to do so."

It may be added that, in many cases, there should be a fairly constant ratio between the amount of outstanding book debts and the total of the sales on credit during (say) the last three months.

Although it is very undesirable that an insufficient provision be made for bad debts, it should—on the other hand—be remembered that, when once a debt is written off, its chance of being eventually collected is greatly discounted; and, further, that there is at least the possibility of its not being accounted for, even if collected: hence the advisability of adopting the system already described. (*Vide* page 77.)

OUTSTANDING DISCOUNTS.

The usual cash discounts, upon both book debts and trade creditors are sometimes provided for by means of a suspense account. Where, however, the amount is uncertain (by reason of the variable nature of the payments) and the difference between the two sides is but slight, the provision might be omitted without any great harm being done—indeed, it is a very open question whether the profit or loss—as the case may be—ought to be anticipated. *Trade* discounts are, however, a very different matter, and should be provided for by deduction from the purchases and sales respectively.

It has been stated that every credit transaction involves the consideration of interest or discount—a statement which is, doubtless, theoretically unassailable, but practically inconvenient. As a matter of fact, there is no relation between the usual so-called "cash" discount and the rate which is paid for

borrowed money. These discounts run from ½ of 1% for cash within ten days, to 5% for the same period, the terms in both cases being thirty days net. It is not to be presumed that in one case the trader is willing to pay 9% per annum for prompt collections and in the other case 90%. It is merely a *premium* or *bonus* paid for prompt payment, and in most cases is in effect a trade discount.

In the case of banks and other financial houses, interest (which is no longer obscured by trade profits, but is itself the source of all profit) should, of course, be *always* taken into account, but, as stated heretofore, the almost invariable practice for American banks is to ignore this matter.

DIRECTORS' FEES.

In the absence of any special arrangement contained either in the articles of association or in the minutes of general meeting, directors are entitled to no remuneration in respect of their services. The auditor will require to see, therefore, before passing any such remuneration, that provision is contained therefor in the by-laws, or else that the remuneration has been voted by the stockholders in general meeting. He would also require to see that the amount which the directors have received is in accordance with such provisions. Proper vouchers should be given by directors for fees received by them. It is not likely that under any circumstances objection could be raised to reasonable attendance fees, but it would seem from reference to leading American authorities on our corporation laws that the practice of voting large salaries and other compensation to directors is *ultra vires*. Of course, if the by-laws distinctly provide for such compensation, no objection can be raised. It is, perhaps, superfluous to state that no one who is not a director can be entitled to receive directors' fees, and it is a very fair question as to whether directors who are also officers of a company, and who draw salaries as such, are entitled to receive directors' fees in addition.

PRELIMINARY EXPENSES.

In the balance sheet of almost every young company this item will be found among the assets. It will probably surprise few, to learn that with a considerable number of companies this item is not written off, and, while it disappears as a separate item, it remains capitalized. It is, however, very desirable to write off the amount of the preliminary expenses within the first three or five years; and the auditor will do well to recommend the adoption of such a course.

It must not be forgotten that, in every case, the auditor must thoroughly verify the amount of this item by reference to vouchers and contracts. In particular, he should make sure that the company has made no payments that the promoters undertook to pay, or which—for other reasons—may appear improper. It is not an unknown occurrence for directors' qualifications to be paid for out of preliminary expenses.

RESERVE FUNDS.

It is very generally conceded, and therefore need not be discussed at length in these pages, that it is not—under ordinary circumstances—desirable that a reserve fund be specially invested if the moneys can be utilized to better advantage in the business itself or in reducing its liabilities. Where, however, the fund is specially raised for a specific purpose (*e. g.*, the redemption of bonds), its investment would appear to be desirable for the purpose of insuring its being available at the appointed time. Of course, wherever a specific provision is made in a mortgage (as is frequently the case) requiring the fund to be invested, it will be necessary to carefully examine all the provisions relating thereto in order to be sure that the investments are properly made. Where the reserve fund exists for the purpose of strengthening the credit of the company—as in the case of banks—it is doubtless desirable that it should be invested in first-class securities; but it is no part of the auditor's functions to interfere with the management in this

respect. The whole subject is, however, dealt with very fully in the following chapter.

Unless there is a special provision in the by-laws, there is nothing to prevent directors from transferring the whole or any portion of the amount standing to the credit of reserve fund to the credit of profit and loss account, for the purpose of increasing the amount of profits available for dividends. Where such a course is being pursued, the auditor should, however, take steps to acquaint the stockholders with the facts, unless they are shown with sufficient clearness on the face of the accounts.

It is obviously desirable that premiums received on issues of stocks should be placed to the credit of a permanent reserve fund, and not applied to the equalization of dividends; nor should they be included in the surplus, or current profit and loss account, as ordinary earnings or income. With respect to premiums received on bond issues (if the premium arises as a matter of fact from the rate of interest which the bonds bear), it would seem proper that the premiums so received should be set up and distributed ratably over the life of the bonds as a reduction of the current interest account. This, of course, follows the theory laid down with respect to bonds issued at a discount.

INSPECTION OF MINUTE BOOK.

The question frequently arises, and is the source of no little contention, as to whether an auditor has the right to inspect the minute book recording the proceedings at board meetings. It is thought, however, that this right cannot be disputed, inasmuch as it is clearly the duty of the auditor to certify to the accounts after having examined "the books of the company;" and certainly the minute book is a "book of the company," inasmuch as it is one of the few books which every company is required by all corporation laws to keep. Theoretically, at least, it is necessary that the auditor should carefully examine

the whole contents of the minute book, but in practice it is thought that this rule may frequently be relaxed, and reference only made in respect to items upon which the auditor is in doubt, or with regard to which he requires further elucidation. It need hardly be added, however, that in this respect—as with regard to all other matters where the auditor prefers to take a short cut in his work—he does so at his own risk, and the risk in this particular connection is that he may fail to become acquainted with some contingent liability or contract which would materially alter his views with reference to the accounts which he is called upon to certify.

If an auditor is refused facilities for performing his duties, whether such refusal takes the form of declining to allow him access to any of the books, accounts, or vouchers of the company, or to the failure of the directors or officers of the company to give such information or explanations as may be necessary, the auditor should sign a certificate at the foot of the balance sheet stating that all his duties as auditor have not been complied with.

REDEEMABLE STOCKS AND BONDS.

Where preference stocks or bonds, redeemable at par or at a premium, have been issued at a lower rate, it is essential that a proper reserve be made to meet the deficit; and it will be the auditor's duty to see that a sufficient provision is made.

FORFEITED SHARES.

Where shares have, for any reason, been forfeited to the company, and have not been re-issued, they should be separately stated on the balance sheet, as a dividend declared would not be payable in respect thereof. Such shares may at any subsequent date be re-issued at any discount not exceeding the amount per share already received, and when so re-issued the amount already paid (or so much thereof as represents profit) should be treated as a premium upon issue, and credited to a

reserve account. The auditor should always make a point of seeing that the minutes as to forfeiture and as to the calls due are *prima facie* in order.

FLUCTUATIONS IN ASSETS AND SECRET RESERVES.

This most debatable subject is approached with considerable diffidence. Very much can be (and has been) said upon both sides of the question, making it a most difficult thing to say what is really the correct course to adopt in any particular case; and, if the question be complicated, even when a particular instance is judged upon its merits, how much more difficult is it to lay down any general rules of universal application.

The object of all secret reserves created in good faith is to equalize dividends, or to equalize apparent profits; and, in the case of banks and similar institutions, it must be admitted that, were accounts published showing considerable fluctuations in the amount of profits earned, the result might readily be to produce a feeling of disquietude which was altogether unwarranted by the actual facts. More particularly in the case of banks largely affected by fluctuations in exchange does it seem desirable that the temporary effect of such fluctuations should be excluded from published accounts. The understating of assets in profitable years (which is the ordinary means of providing a secret reserve) clearly contemplates, however, the possibility of their being written up in less profitable years, when it may be desired not to disclose the fact that the profit earned has been less than usual, or perhaps even insufficient to cover the proposed dividend.

Opinions differ greatly as to the extent to which the formation of secret reserves is permissible; but it is thought that, within reasonable limits, the matter is one resting with the directors rather than with the auditor, so long as there is no suspicion of bad faith. It is when it is sought to have recourse to a secret reserve by writing up the assets which have hitherto

been undervalued that the position requires the most serious consideration of the auditor.

With regard to the position of the auditor generally, it would appear that, in the absence of *mala fides,* he incurs but little responsibility. He should, however, be very careful about the good faith with which the valuations or re-valuations are made, and although he has no power to influence the management in the exercise of their *bona fide* discretion, yet it would appear to be clearly his duty, in cases of doubt, to sufficiently acquaint the stockholders with the facts of the case to enable them to intelligently exercise their own discretion as to whether they will pass the accounts in the form in which they are presented to them or not. Thus, where the assets are stated below their certainly-known value (forming a secret reserve), or above their certainly-known value (forming a secret deficit), at least the bare fact should be mentioned in the auditor's report. Again, there are limits to the extent with which a secret reserve should be played with, for the sake of equalizing dividends; and it is very undesirable that valuable assets should be omitted from the balance sheet *in toto,* because in such a case the auditor is very liable to omit to verify their existence. In some balance sheets a note is appended to the effect that certain (specified) assets have not been included. Such a course appears to remove the most weighty objections that can be raised against the reduction of valuable assets to zero, but it does not altogether justify the course adopted.

FOREIGN EXCHANGES.

The treatment of foreign exchanges in books of account appertains to bookkeeping rather than auditing, and the subject will accordingly be found fully dealt with in the author's "Advanced Accounting." From the point of view of the auditor, all that is necessary is that the accounts should properly disclose the true position of affairs. For this purpose it is only necessary to bear in mind that the trial balance (from which the accounts are compiled) is a summary of *transactions*

that have actually taken place, temporarily recorded, for the sake of convenience, in the medium of a foreign currency. To determine their proper valuation in dollars it is necessary that the nature of these various records should be inquired into; that the revenue account (whatever its precise form) should correctly show, under suitable headings, the totals of the various kinds of transactions on account of revenue, and that the balance sheet should fairly state the assets and liabilities—those of a current nature at their realizable cash value, while the fixed or permanent items may be maintained at the original amount, subject only to such provision for depreciation as may be necessary in view of their wasting character. If this position of affairs be correctly comprehended, there is no more difficulty in auditing accounts figured in a foreign currency than in auditing accounts the narration of which is expressed in a foreign language. The medium of expression in neither case affects the nature of the facts.

ULTRA VIRES.

It is a question of some nicety as to how far an auditor is expected to concern himself with the validity of the transactions that come under his notice. It may be taken that, in general, the auditor is not constituted a judge of the conduct of the directors in their administrative capacity; and that, so long as the accounts are in order, and in accordance with such statutory provisions as may affect the particular undertaking, and its articles of association (or their equivalent), the auditor need not concern himself with questions which his professional training has not especially qualified him to solve. It is clear, however that when the auditor is aware that irregularities have been committed, it becomes his duty to report the whole circumstances to the stockholders.

"AFTER DISCOVERED EVIDENCE."

The question has sometimes been raised as to how far, if at all, an auditor should take cognizance of events transpiring be-

tween the date of the balance sheet which he is to certify and the date he actually completes the audit. It has been contended by some that the auditor should view the accounts in the same way he would have done had he actually made his audit (which, of course, he would be unable to do) on the day with which the audit period closed and that he should not be influenced by circumstances which were unknown at that time.

This contention is short-sighted and ultra-technical. If the auditor, prior to certifying to the accounts, comes into possession of information indicating a material difference between the books and *facts as they actually were at the date of the balance sheet* (even if the true facts have only been ascertained since that time) and he certifies to a balance sheet drawn from the books without any adjustment being made to bring it into accord with the facts, he is certifying a balance sheet which is *not correct according to the best of his information.*

It should, however, be borne in mind that these remarks apply only to circumstances transpiring in the interval which throw light on the actual condition of affairs at the date of the balance sheet and do not, of course, apply to events which may have occurred in the intervening period to the detriment of a company's financial condition—such as a fire loss exceeding the amount of insurance recovered—which have no connection with a prior period.

FORM OF ACCOUNTS.

In the audit of private accounts and most corporations it is usual for the auditor to recommend the particular form in which the accounts shall be cast. In the case of national banks, however, the auditor has no power to dictate the form in which the accounts shall be stated, consequently he need not concern himself with the consideration as to whether or not the form adopted is the most suitable one under the particular circumstances of the case; but, if he is convinced that the form adopted is one calculated to mislead, he should not hesitate to

modify his report accordingly. Nevertheless, the whole question is one of considerable interest and accordingly it has been thought desirable to deal with it at some length in the following chapter.

Where a statutory form of accounts (as is the case, in some States, with railway and insurance companies) has been provided, the auditor should see that the accounts are prepared in accordance with that form, or as nearly in accordance therewith as circumstances will permit.

CHAPTER VII.

FORM OF ACCOUNTS AND BALANCE SHEETS.

It has already been clearly stated that, in general, the auditor is not responsible for the form of accounts which he certifies. The consideration of the form that such accounts should properly take is, therefore, not strictly a matter within the scope of the present work. Still, it is none the less true that, as a matter of fact, auditors are frequently asked to settle questions of form; and although in the case of certain undertakings like banks and insurance companies, where departmental forms are prescribed, they will often be only prudent if they decline to accept a responsibility that properly devolves upon the directors, there can, it is thought, be no possible objection in the case of the accounts of private firms. Moreover, it cannot be denied that the subject is at all times one upon which the auditor should have definite and well-matured opinions.

The form of accounts to be submitted by public service corporations has received much more attention than the form of the accounts of industrial corporations. This is due in part to the efficient work done by the various societies and associations of accounting officers, such as the Association of American Railway Accounting Officers and the Street Railway Accountants' Association, which devised uniform systems of accounting and urged their adoption. The governmental regulation of railroads and public utilities which necessitated the use of prescribed forms of report has also been a factor. Furthermore, it should be remembered that these undertakings lend themselves more readily to uniformity of statement than

industrial enterprises wherein the conditions existing, even in the case of concerns in the same line of business, are frequently so dissimilar. The American Association of Public Accountants has also been active in this direction; one committee has submitted forms for Standard Schedules and Uniform Reports upon Municipal and Public Service Corporations, while during the New York insurance investigation of several years ago a joint committee of the Association and the New York State Society of Certified Public Accountants prepared model forms for the reports of life insurance companies which are a great improvement over the forms in use by the Insurance Departments of the various States.

With regard to the published reports of industrial corporations great divergence of form still obtains and some of them seem to be prepared with the thought that the less shown the better, otherwise the stockholder may really learn something about the operations and financial condition of his company. It is hoped, however, that the growing custom of submitting the accounts to Certified Public Accountants for audit will result in considerable improvement in this respect, and that, while it is not to be expected that there will be uniformity of detail, there will be more uniformity as to principle and the essentials which such reports should contain.

In Appendix D are presented a number of forms of accounts which have been gathered from different sources and which will indicate what has been accomplished in this direction.

It may be stated at the outset that the accounts with which it is now proposed to deal are those which are ordinarily published as "the audited accounts"—viz., the Revenue Account (or its equivalents) and the Balance Sheet.

OBJECT OF REVENUE ACCOUNTS.

Taking first the account which in different undertakings is variously called the trading account, the manufacturing account, the profit and loss account, and the revenue account, the first point to be considered is the real object of preparing such

an account. This may be stated to be for the purpose of showing—

First, the amount of business done in each of the various branches in which business is carried on;

Second, the amount of expenditure in each of the branches, or departments, necessary for the carrying on of that business; and,

Third, the amount of surplus, or profit—or loss, as the case may be—which arises from the carrying on of the business.

The object of the information is doubtless primarily to ascertain the amount of ultimate profit or loss, but beyond this there is also the further object—which, perhaps, is only fully appreciated by those skilled in accounts—of comparing the corresponding items of various periods, with a view to ascertain how income may be increased and expenditure reduced, or, on the other hand (so far as possible), *why* income has become reduced and *why* expenditure has increased.

It will thus be seen that the efficiency of this account depends very materially upon the skill with which the income and expenditure have been distributed over the various headings employed, and consequently it becomes necessary to discuss the nature of the various headings under which the items of this account should be divided.

It goes without saying that, inasmuch as this account details the summarized result of the transactions recorded in the books, its exact nature will very materially depend upon the precise business which is being carried on. It therefore becomes necessary to further consider the subject under the headings of various classes of business.

COMMERCIAL ACCOUNTS.

Taking first commercial concerns (which undoubtedly represent the great majority of the undertakings which are now

being considered), it will be found that the transactions consist in the buying of goods and the selling thereof, either in the precise form in which they were purchased (as in the case of traders), or in an altered form (as in the case of manufacturers); in both cases there being the further expenditure incidental to the carrying on of the undertaking.

ACCOUNTS OF TRADERS.—The accounts of traders are naturally of a simpler nature than those which require to be kept by manufacturers. A trader's revenue or profit and loss account should show clearly at least three things:

1st. The gross business or turnover during the period.

2nd. The gross profit thereon and the ratio of one to the other.

3rd. Whether the volume of business has been large enough to produce a gross profit sufficient to provide for the selling and administrative expenses and a net profit.

It would be very difficult to find an exact definition of the term "gross profit," inasmuch as the items from which it is calculated will be found to vary in different undertakings; but seeing that the whole business of a trader is based upon the calculation of a fixed percentage of gross profit upon each different class of goods dealt with, it necessarily follows that any form of accounts which does not recognize the existence of such a thing as "gross profit" fails to afford the trader that assistance which he is entitled to look for from his accounts, and consequently to a very great extent fails to justify its existence.

It has been argued by many experienced accountants that gross profit cannot be considered to arise until such things as rent of warehouse, salaries of warehousemen, &c., have been debited to the trading account; but as it is the almost universal custom of traders to reckon their percentage of

gross profit entirely from the cost price of their *goods* (although, as a matter of convenience, they actually make the calculation backwards from their selling price) it would seem that, however correct it may be in theory, it is in practice nothing more than pedantic to include in this first section of the account anything more than "Sales" upon the credit side, and the opening "Stock" plus "Purchases" and minus the closing "Stock" upon the debit. It is, of course, quite possible to argue that the resultant credit balance means absolutely nothing at all; but, even if this were so, the fact remains that unless the account be so prepared it is impossible to see whether the aggregate transactions of a period actually result in the percentage of gross profit which the trader had been calculating upon throughout that period; and, therefore, whether it is thought best to call the balance of this first section "Gross Profit," or to employ the indefinite term "Balance," the overwhelming weight of advantage lies in bringing the account—in this respect at least—into accord with the custom of every trader, and so enabling him to ascertain whether during any period he has actually achieved the results which he anticipated.

In the second section of the revenue account may be included all items of income and expenditure relating to the business. These expenses should be grouped in convenient subsections, so that the effect of each group upon the whole may be readily perceived. This is useful both for the purpose of seeing how far the net profits of a concern have been affected by purely financial reasons, and how far by commercial reasons, and also on account of the convenience it affords if it should at any future time be decided to convert the venture into a corporation.

MANUFACTURERS' ACCOUNTS.—Passing on to the accounts of manufacturers, it is first necessary to subdivide this heading in accordance with the various classes of business that fall hereunder. There is first of all the class of manu-

facturers but slightly removed from the trader—that is to say, the manufacturer who does not require to sink a large proportion of his capital in expensive plant and machinery, the most typical examples of which are, perhaps, that of the small manufacturing jeweler and the small manufacturing tailor—both of whom, by the way, are fast dying out. In this class, as with traders pure and simple, the selling price is based upon a percentage of so-called "Gross Profit," the outlay in this case being the cost of materials, together with the wages spent upon manufacturing; and, therefore, although the method is clearly indefensible from a theoretical point of view, the division between the first and second sections may conveniently be drawn exactly where it is drawn by the manufacturer himself in his mental calculations. Those who wish to have their accounts as complete as possible may prefer in addition to make a further subdivision of this account in the second section, separating the expenses of manufacturing (such as rent of factory, wages paid for supervision of workers, depreciation of plant, &c.) from those expenses which relate more particularly to the storing of goods and the selling thereof; but inasmuch as the balance shown by this break would correspond with nothing in the mind of the manufacturer it appears to be superfluous, and it will probably be thought sufficient to merely show separate totals for these classes of expenditure in the same section.

The manufacturers belonging to the next class are those whose transactions consist in the manufacture of one or more classes of goods involving expensive plant, which goods are first manufactured and then warehoused before being sold. These undertakings are naturally upon a much larger scale than those which have just been considered, and consequently it will be found that the accounts are, as a rule, more scientifically kept, and the method of costing more complete.

The first section of the account thus becomes divided into two parts upon what may be called parallel lines, viz:—

The manufacturing account, which deals with the conversion of raw material into manufactured articles, and shows the cost of manufacture and the stock of raw materials on hand.

The trading account proper, drawn upon the same lines as the first section of a trader's profit and loss account.

The second section of the account does not present any new features that call for consideration.

The expenses included in the manufacturing account will (as a rule) be those which are dealt with in the cost accounts, and those only. It is quite likely, therefore, that factory expenses would be debited to the manufacturing account, rather than to the profit and loss account, although the effect of so doing will be to obscure the percentage of (so-called) gross profit.

CONTRACTORS' ACCOUNTS.—The next class of manufacturers to be dealt with consists of those that may conveniently be summarized under the head of "Contractors," *i. e.*, those manufacturers who only make articles which have already been sold for an agreed price. To this class belong builders and many engineers.

It is in this class as much as anywhere that the absolute necessity of proper cost accounts is so evident. Indeed, all contractors' accounts may be regarded as incomplete which do not provide, in addition to any ordinary profit and loss account, a "Summary of Cost Account," showing the same results. This being done, the chief interest centres round the cost account rather than the profit and loss account itself, and there is thus less necessity for the latter to be unduly elaborate. It is therefore usually best to state this latter account in one section only.

It is, perhaps, unnecessary to add that, in practice, an absolute agreement between the profit and loss account and the sum-

mary of cost account is hardly to be expected; but a very close approximation must be arrived at before either can be safely relied upon.

STATISTICAL INFORMATION.—In connection with all the preceding accounts it will usually be found of the very greatest assistance to add statistical columns, for the purpose of showing the relation which each item bears to the amount of trade done. This relation will usually be expressed in the form of a percentage on the amount of the sales, but where the business deals with articles of a uniform or similar character—as, for instance, in the case of collieries, brickyards, and the like—the percentage will probably be based upon some quantity, or unit, of the goods dealt in, as "per ton of coal" or "per thousand bricks," and in these cases it is usually thought more convenient for the unit to be the production rather than the sale.

In published accounts it is also somewhat usual, and very convenient, to publish, side by side with the figures for the current period, those for the next preceding period, for the purposes of comparison. For the sake of clearness the figures for the current period appear first, and sometimes it is desirable to have the figures of the preceding period appear in red ink or italics, or some other type which may be readily distinguished from that in which the accounts for the current year or period are printed.

MINING ACCOUNTS.

Another very important class of accounts, which can hardly be said to come under any of the previous headings, is that relating to mines. These accounts are best dealt with in two sections: one to include all items relating to the actual working of the undertaking; and the other, those appertaining more particularly to finance. Cost accounts would be made weekly or monthly, but they would usually form no part of the annual accounts.

"NET PROFIT."

This is, perhaps, the proper place to offer a protest against the method adopted by many companies of stating in their published accounts a so-called "Net Profit," *out of* which it is proposed to set aside a certain sum for depreciation. A true net profit can only be arrived at after charging up *all* expenses —including, of course, depreciation, interest on bonds, &c., &c.

BALANCE SHEETS.

Turning now to the question of balance sheets, perhaps the first point to be disposed of is the question "What are assets?"

WHAT ARE ASSETS?

Going back to first principles, it must be admitted that an asset may be fairly defined as "an expenditure upon a remunerative object," and, indeed, it may be taken as the test of whether any particular expenditure is an asset or a loss to inquire whether as a matter of fact such expenditure was—looking back upon it—worth the amount expended upon it. This applies whether the expenditure is in the nature of capital spent in the purchase or construction of any particular property, or in the purchase of property or labor which was subsequently sold to another. In the former case, if—looking back upon it—it is considered that if the opportunity of making the investment a second time should again arise it might reasonably be made upon the same terms, it may fairly be said that there is value for the original outlay; and in the latter case, if—looking back upon it in the light of present experience—one would again sell upon trust to any particular individual property upon which time or money had been expended, it may fairly be said that value is still remaining for the amount with which it at present stands charged. If, on the other hand, it appears that the value remaining for such expenditure is less than the original amount of such expenditure, it is obvious that, as a matter of fact, depreciation has occurred.

NECESSITY FOR DEPRECIATION.

It appears doubtful as to whether any of our laws *compel* a company to make provision for depreciation before declaring dividends out of its earnings, although our courts will probably be called upon to pass on this question in the near future, and if the principle involved is clearly stated, it is more than likely that it will be judicially determined that depreciation is a charge *against profits*. It is unfortunate that the question of depreciation was not raised in the American Malting case. It was not necessary, however, as the other losses were sufficient to offset all of the dividends paid.

The question of depreciation is, therefore, rather one of prudence, or internal administration, than of legal compulsion.

METHOD OF PROVIDING DEPRECIATION.—Many companies deem it undesirable to deduct the depreciation from the cost shown in the capital expenditure account, and the method adopted is to accumulate the amount set aside from time to time upon a depreciation (fund) account, or a reserve for repairs and renewals account, which is included as a liability in the general balance sheet (although not necessarily stated separately). On the other hand, the more usual course is to deduct the amount written off for depreciation from the amount at which the value of the asset is stated, and this whether the asset account and depreciation account are kept separate in the ledger or not.

FORM OF BALANCE SHEET.

The various items which are ordinarily found upon a balance sheet will now be dealt with in order, and the best form of wording under various circumstances considered.

The form generally accepted in England places the liabilities upon the left-hand side and the assets upon the right-hand side, commencing upon both sides with the most permanent items,

and leaving those which are most constantly varying to the last. This is, in fact, the form provided in their Companies Act of 1862.

In the United States, however, while statutory forms practically do not exist, yet the practice of placing the assets on the right and liabilities on the left is without a single known exception reversed, and this may be said to have the effect of law with us.

Under the Italian system of bookkeeping, which is still practiced in some old-fashioned merchants' houses it is the custom at every period of balancing, after the nominal accounts have been closed, to transfer the balances of the real and personal accounts into one account, usually called in England and in the United States the "Balance Account," and in France the *"Balance de Sortir,"* or "Closing Balance." Under such circumstances, the ledger would be actually closed (which, in fact, is never the case under the ordinary system), and the Balance Account so raised would practically be a detailed balance sheet, with the assets upon the Dr. and the liabilities upon the Cr. side, as shown in all of our balance sheets.

It may be that assets always appearing on the left-hand side of the ledger explains our present system, which also seems to correspond with the Italian method referred to, but in view of the fact that our present practice is settled, and inasmuch as there does not seem to have been a single objection raised on account of its being unscientific, or for any other reason, it would seem unnecessary to discuss the reasons which must have governed those responsible for stating our balance sheets diametrically different from the English method.

We shall, therefore, first treat of the asset or left-hand side of the balance sheet.

It might be well, however, before going further, to mention that probably nine out of ten published balance sheets include items under "Assets" and "Liabilities" which certainly are

not either one. This is to be deplored because professional auditors are looked to not only as authorities on form, but also as authorities on principle. It certainly cannot be successfully contended that a debit balance to profit and loss, or a deficit, is an asset nor *per contra* is a credit balance to Profit and Loss, or a surplus, a liability. Furthermore the share capital of a corporation is no more of a liability than is partners' capital in a partnership.

It is only possible to justify the inclusion of *any* item in a balance sheet, provided—at that time at least—it is reasonable to treat it *as* an asset, or a liability, as the case may be.

Inasmuch as these headings are always attached to balance sheets, the incongruity of non-permissible items is emphasized, but it does not seem to have any effect. It may be urged that this course is necessary for the sake of convenience, and that in order to intelligently group the right and left-hand sides the footings must be equal. This reasoning is so opposed to the principles of accountancy that it hardly merits an answer. Perhaps the best illustration of this point is found in the case of a professional auditor who is asked to address a body of accountant students on the topic, let us say, "*What are* Assets and Liabilities?" It is not supposed for a moment that he will state that actual net losses of operation, represented by a debit balance to profit and loss, should be carried on a balance sheet under the heading of assets, nor will he explain that accumulated and unapportioned profits are properly stated under "Liabilities." He may take a middle course with regard to the share capital which, while not a liability so far as creditors are concerned, may be so termed with respect to the company's position to its stockholders.

Imagine, then, the same students reading a published report containing a balance sheet prepared by the same professional auditor containing the items just mentioned stated boldly as assets or liabilities as the case might be. And all for the sake of convenience!

THE ASSET SIDE.

The order in which assets should be stated on a balance sheet is a somewhat disputed point among American accountants. It is the opinion of many leading practitioners that assets should be stated in the order of their convertibility; that is, cash would be first, followed by accounts and bills receivable, stock and all other "quick" assets, while the fixed assets would be last. One important point urged in favor of this order is that a balance sheet should be framed, so far as possible, for the convenient use of those for whom it is intended. The majority of balance sheets are submitted at one time or another to bankers, who almost invariably look first for "quick" assets on one side, and the accounts and bills payable on the other.

The reverse order is becoming quite general, however, in stating the accounts of railroads and large industrial enterprises. The practice as to this point is not yet definitely settled, and we shall, therefore, for convenience consider the various items in the same order as they appear in "Table A" of the English Companies Act already referred to.

FIXED ASSETS.—In the majority of cases the titles of the accounts which represent fixed or capital assets are not illuminating, and it is becoming more and more frequent in large corporations to include practically all of their assets of this character under one caption, such as "Plant," and it accordingly becomes almost impossible to gain an intelligent idea of their resources.

Where it is possible to do so, the fixed assets should be divided into land, buildings, machinery, patents, goodwill, &c., and it should be clearly shown whether they are carried at cost or whether proper depreciation has been allowed.

The chief difficulties in the way of preparing such a statement are, first, the over-valuation of assets to balance large capital stock issues, and the consequent temptation to hide the real facts by lumping all the fixed assets; and, secondly, the

large number of cases of holding companies and consolidations where the fixed assets have passed through so many stages that their original identity is lost.

Professional auditors are not the only ones who criticise such reports, as is evidenced by the numerous comments on one of the annual balance sheets of the Amalgamated Copper Company.

The following extract from one of New York's leading dailies is representative of the views generally expressed:—

"An unverified balance sheet is not very satisfying. Of course, there was the usual accountants' certificate of the correctness of the accounts, and no disparagement of that is intended. The point is that something different was called for as a basis for any conviction regarding present or future worth. There was, for instance, an entry in a single line of investments of $154,281,303, with no list of them, and no expert appraisal of the physical condition of the properties. The surplus is almost wholly balanced by loans to a subsidiary company, the cash on hand is only $2,756,759, and if there has been any writing off upon account of exhaustion of ore through payment of dividends aggregating $29,100,000, it is well concealed."

CURRENT OR "QUICK" ASSETS.—Next in order we find Stock-in-Trade. This point was exhaustively covered in the paper of A. Lowes Dickinson, F.C.A., C.P.A., which was read at the St. Louis Congress of Accountants, where he said:—

"Stocks on Hand.—Perhaps one of the most difficult questions which accountants have to decide is the correct enumeration and valuation of stocks on hand. The theory governing the valuation of this asset is that, inasmuch as no profits can be realized until the goods are actually sold, it is not safe to take credit for any profit thereon until a sale has been effected; that, therefore, it should be carried forward at the exact cost, and no profit thereon brought into the accounts of the fiscal period. On the other hand, it may be found that the prices both of the raw materials and the finished product have at the close of the fiscal year fallen below their cost, and while it is impossible to say until the goods have been sold whether any loss will ultimately be made thereon, at any rate there is a possibility thereof. It is, therefore, conservative to set aside a sufficient reserve out of profits which have been realized on goods already sold to provide for the accruing loss on those

which remain in hand. Hence the general rule for valuation of stocks on hand, namely, 'cost or market, whichever is the lower,' has been evolved, and is adopted by the most conservative commercial institutions. Unfortunately, in practice, many concerns are unable to ascertain the cost of their various products, with the result that their stock valuations are based entirely on estimates of costs made with more or less accuracy. There does not appear to be any legal obligation on a corporation to adopt any particular basis, provided that the price adopted is not in excess of that ultimately realized after deduction of any subsequent cost of completion, storage and sale; but the absence of approximately exact knowledge as to the cost frequently leads to disappointment, both to the directors and stockholders, and even to serious financial loss. It is obvious that a constantly changing basis of cost must lead to serious inequalities in the profits shown between one period and another, but it is not equally obvious to the commercial community that an erroneous basis of valuation consistently adopted year after year, even if that basis be a conservative one and really below true cost, may result in large and unexpected discrepancies between the profits shown in different periods. For instance, if stocks be valued on a basis exceeding cost and the trade, and consequently the materials and products on hand increase very rapidly for one or more years, the profits during those years of increase will be abnormally inflated; but when the trade settles down to a comparatively steady turn-over, there will be a considerable drop in the profits as compared with the preceding year on the same amount of business done—a drop which the management, as a rule, will be unable to account for until an investigation by the public accountant discloses the true cause. On the other hand, if the stocks be conservatively valued considerably below cost, the profits of a year in which a small quantity of goods is carried over at the close of the year in comparison with the beginning will be inflated as compared with a succeeding year, when an opposite condition prevailed, although the sales and profit thereon may have been the same in both years; thus entirely upsetting all the calculations and estimates of the managers. The essentials, therefore, for ascertaining correct profits so far as stocks on hand are concerned are:

(*a*) An accurate enumeration of the quantities on hand.

(*b*) An accurate ascertainment of the actual cost of the different manufactured articles, either completed or in progress.

(*c*) A specific reduction in the prices of raw materials of the amount by which the market valuations at the close of the fiscal period fell short of the cost.

(*d*) A proper provision for all stock which is old or depreciated, or for any reason likely to be unsaleable.

"The more exactly these different elements are ascertained, the more accurate will be the resulting statements of profits, and if the special reserves be made separately, it will be an easy matter to compare usefully one period with another.

"Finally, it should be noted that it is not essential, and, in fact, it will frequently be incorrect, to value materials and products on hand at the end of the fiscal period upon the same price basis as at the commencement of that period; all that is necessary or proper is that the basis of valuation—that is to say, the principles on which the values are arrived at—should be the same at the beginning and end of the period, the actual prices usually varying from one year to another."

Next come "DEBTS OWING TO THE COMPANY," which are grouped under headings as follows:—

Debts considered good, for which the company holds notes or other securities.

Debts considered good, for which the company holds no security.

Debts considered doubtful and bad.

It is also provided that "any debt due from a director or any other officer of the company is to be separately stated."

It is not usually considered desirable to separately state the amount of the doubtful and bad debts, but the provision for the separate statement of any debt due from a director or other officer is one that should not be lost sight of; doubtless, it is not intended to apply in the case of debts for small amounts in the regular course of business, but cases will readily occur to the reader in connection with some recent failures where the compliance with this provision might have materially affected the course of events.

If such a rule had been enforced in recent years with respect to loans to directors of national banks, many millions of dollars of depositors' money would have been saved.

The next item on the Balance Sheet is INVESTMENTS, which should be stated in some detail, and if the investments

are on account of reserve fund account or sinking fund account, the circumstance should be clearly stated.

Mr. Dickinson's paper also dealt with this caption in some detail, and his entire comment is reproduced:—

"MARKETABLE INVESTMENTS.—The term marketable investments is intended to include only such investments as are part of the circulating as distinct from the fixed assets. The latter class of investments may be defined as those which cannot be disposed of without affecting the operations, for the reason that the ownership thereof in a permanent form is necessary, however remotely, to the business which the corporation is carrying on. Their valuation would be governed by the same principles as have been outlined above for other fixed assets.

'Marketable investments, on the other hand, may be either:

(*a*) The stock in trade of the corporation, or

(*b*) The investment of surplus cash held in this form until required for ordinary operating purposes, or

(*c*) The investment of a reserve or other special fund.

"In case (*a*) the rule of cost or market value, whichever is the lower, applied to each individual investment, and not to the group as a whole, is undoubtedly the most conservative. That is to say, no profit could be taken up on any investment until it is sold, but on the other hand, where the value has clearly fallen, some provision should be made therefor. Where, however, the investments all have a definitely ascertainable market value at any time, it is, perhaps, fair and reasonable to allow a fall in value of some individual investments to be set off against a rise in value of others, provided that the aggregate valuation is not above original cost or market value, whichever is the lower.

"In case (*b*) the usual custom is to value at the mean market price on the last day of the fiscal period for the reason that the investments represent the equivalent of cash, and should, therefore, be maintained at their cash value in the balance sheet.

"In case (*c*) any profit or loss, either realized or estimated, would be a credit or charge to that fund, and not to the profit and loss account. But in the balance sheet such investments should either be clearly stated as maintained at cost or preferably be adjusted each year to the aggregate market value if below cost.

"Another method of dealing with the fluctuations of marketable investments of classes (*b*) and (*c*) is to create an investment fluctuation reserve, either out of estimated or realized profits on investments, or by

a charge to profit and loss of such an amount as may be necessary to prevent this reserve from showing a debit balance, and by charges or credits to this reserve to maintain the asset at market value."

The corporations in whose balance sheets marketable investments play a leading part are insurance companies, banks (more particularly savings banks) and trust compaines. In all states, so far as is known, the solvency of insurance companies is tested by the sufficiency of the assets (valuing stocks and bonds at the market prices) to meet the present value of policy contracts in force and sundry other liabilities. Owing to the abnormal decline in the market values of securities in the fall of 1907 the statements of almost all the life insurance companies at December 31, 1907, showed a startling decrease in surplus as compared with the close of the preceding year. This shrinkage attracted considerable attention, and as the corporate bonds owned (the fall in whose market quotations was largely responsible therefor) were yielding the same rate of income as when purchased, and as there was no serious question as to the security of the principal of most of them, emphasis was given to the question of whether the basis of so called market value was not an erroneous one.

Mr. John Tatlock, then President of the Washington Life Insurance Company, discussed the matter very fully in a paper "On the Proper Method of Valuation of Fixed Term Securities Owned by Life Insurance Companies" which was read at a meeting of the Association of Life Insurance Presidents. The following paragraphs are quoted therefrom:

"As is well known, the current practice adopted in the valuation of bonds is to allow values therefor which represent the actual prices at which a few bonds have changed hands on, or as near thereto as may be, the date of accounting. In the case of bonds which have a wide and active market the necessary information is supplied by the record of public transactions; for securities which appear less frequently in actual transactions information is sought from dealers concerned in such transactions, the resulting values being based thereby more or less upon individual opinion and the possible market available to the individual dealer; and bonds which, on account of the extreme infrequency of

transactions therein, constitute a third and distinctive class, are oft-times credited at amounts which aptly illustrate the force of a recently resurrected and adapted epigram to the effect that 'Value is a state of mind.' . . . . .

"In seeking to establish the reasons for making objection to the practice of valuing bonds at market values, it becomes proper to look into the cause, or causes, of market fluctuations of the class of securities now under review. Passing over minor considerations, it may be stated that in general these fluctuations depend upon and vary with the market rate of interest, or the measure of the demand for money for use in the customary channels of trade and commerce. This fact emphasizes a strikingly anomalous condition in the accounting methods of life companies. Liabilities are calculated and determined on the assumption that a fixed rate of interest is to be earned on the assets held to offset these liabilities during the period of continuance of the contracts for which the liabilities are set up. In practice the offsetting assets are periodically valued at varying rates of interest which, at times, may be, and are, set so high that the assets so valued fail to reach in amount that necessary to cover the outstanding liabilities. In other words, they are valued to provide, for instance, for a return of 6 per cent., or even 7 per cent., when they were acquired to give a return of from 3½ per cent. to 4½ per cent., to cover liabilities whose offsetting assets are assumed to earn 3 per cent. or 4 per cent. From what source is derived the bulk of the funds acquired by life companies which necessitates investment? It consists of those parts of premiums which constitute contributions to the sinking fund known as the 'reserve' and in the calculation of which no such anomaly, as indicated above, has, nor possibly could have, consideration. It has been stated that the practice of regarding market values of bonds rests upon the supposed analogy between liabilities of life companies and those of banks and similar institutions. In point of fact a wide difference exists. The liabilities of a bank are practically immediate; it is required, from the nature of its business, to provide for possible liquidation within a short space of time. The liabilities of a life company, on the other hand, are provided by contract to mature over a period of a long term of years; the amount of liabilities requiring settlement within a given period, or at a given time, can be determined in advance with a high degree of accuracy, and good management can, and does, provide that assets to meet maturing obligations are in hand when needed, irrespective of the ups and downs of market trading in such assets in the meantime. It is submitted that the whole question of solvency of a life company, to say nothing of its function as a profit-making institution, rests directly upon the principles and practice just enunciated. . . .

"Criticism and the expression of disapproval of an existing order is rarely justified unless followed by the enunciation of a remedy. Bearing in mind that securities are purchased by life companies for permanent investment, the nature and occurrence of the liabilities for which they are an offset and the complicated questions which arise in connection with the division of surplus—reference to which will again be made—it is submitted that the method of valuing bonds, by computing their present value on the basis of the effective, or actual, rate of interest, if held to maturity, which is determined by the prices at which they were originally purchased, meets in a satisfactory manner all the conditions of the problem. The method is not new nor original. It rests upon fundamental principles of interest and annuities, and has been used for many years by some life companies and many other financial institutions in fixing the book values of bonds. It is easy of application by means of well-known and generally adopted tables. It contains no elements of mystery or pure assumption and involves in its application no exercise of independent judgment. In considering the claims for attention to this method, it is proper to note the nature of that instrument usually called a bond. It consists of an obligation to pay a fixed sum at a stated future date, which sum is called the face value of the bond, and of a series of obligations to pay other fixed sums at the end of periodical intervals of time, usually less than one year, the dates of which occur before and on the fixed date at which the face value of the bond is due. If the rate of return to be realized on a bond corresponds in its proceeds to the amount of the obligation due at the end of each periodical interval, then the present value of the obligations comprised in the bond computed at such rate of return, will, at any date of valuation, be equal to the face value of the bond. Similarly, if the rate of return calls for proceeds which exceed the amount of the periodical obligations, then the present value of the total obligations will, at any time before the face value is due, be less than such face value; if the rate of return calls for proceeds which are less than the amount of the periodical obligations, then the present value of the total obligations will, at any time before the face value is due, be more than such face value.

"Bonds are rarely purchased at par or face value. To make the amount of the purchase merge into the amount at maturity demands an adjustment of accounts. So far as life companies are concerned, different methods prevail. Some, at date of purchase, charge off a premium or credit a discount. Others perform similar operations at time of maturity, carrying the actual cost on their books until that date; others distribute the difference between the face value of the bond and the purchase price by dividing such difference into instalments in proportion to the number of years to maturity, charging off or crediting an instalment each year. All of these methods are open to criticism, be-

cause at any date of valuation the results attained thereby do not show actual facts, especially those pertaining to the interest account. A few companies use the method which is here advocated, the only method which, for certain reasons, is believed to be wholly defensible and worthy of general adoption. These reasons are as follows:

"First. The use of this method results that the amount of the investments, as carried on the books of the company, is at maturity exactly equal to the amount then due.

"Second. This method secures the debits and credits to interest account, at each periodical adjustment of the book value, in accordance with the effective rate of interest, on the basis of which the investment was made.

"Third. The original book value is the actual cost and, at any date of valuation by this method, the book value represents the cost of such portions of the obligations as have not then matured.

"Fourth. This method avoids the necessity of making arbitrary charges or credits to profit and loss account.

"For the sake of completeness, it is proper to remark at this juncture that the statements which have been made refer, of course, to bonds which are expected, without question, to be paid in accordance with their terms. As to others, one may be permitted to quote as follows from a comprehensive memorandum, on the subject of valuation of investments in general, prepared by Mr. Leon O. Fisher, Auditor of the Equitable Life Assurance Society of the United States:

"'Special provision should always be made for any anticipated losses of principal, through the insolvency of the debtor, but such provision should be made by creating special reserves from surplus, rather than by writing down the amortized cost value.'

"While it may be said that attention, more or less public, is now directed to this question of valuation of assets by reason of present financial conditions, too much emphasis cannot be laid upon other and far more important considerations which demand a radical change in rules heretofore requiring a determination of market values. These are to be found in the course of legislation, accomplished and prospective. The conditions of future surplus determination and division are now laid down by statute, and compliance with these conditions can only be secured by pre-arranged rules and methods. Section 83 of the New York Insurance Law reads, in part, as follows:

"'Upon the thirty-first day of December of each year, or as soon thereafter as may be practicable, every such corporation shall well and

truly ascertain the surplus earned by such corporation during said year. After setting aside from such surplus such sums as may be required for the payment of authorized dividends upon the capital stock, if any, and such sums as may properly be held for account of existing deferred dividend policies, and for a contingency reserve not in excess of the amount prescribed in this article, every such corporation shall apportion the remaining surplus equitably to all other policies entitled to share therein.'

"It will be noticed that, the surplus being once determined, the deductions which may be made therefrom are specifically named. No other reservation may be allowed. In a year in which a large advance in market values has obtained, no reserve may be set up, out of the surplus therein earned, as an offset to opposite and adverse conditions which may obtain a year later. Under the market value theory, paper profits must be divided and paper losses must be charged against surplus otherwise actually earned."

It is rather curious that since the panic of 1907 the State of New York has enacted a law requiring savings banks (whose deposit obligations may mature on comparatively short notice) to value their fixed term securities on an amortized cost or "investment value" basis, while life insurance companies, (which can calculate the maturities of their contract obligations with a considerable degree of certainty,) are still required to base their valuations of similar securities on market quotations.

Last upon the assets side is the item of CASH, which may be separated into—

Amount in banks on deposit, including accrued interest.

Amount in hands of agents or at branches.

Amount in hand.

CONTINGENT ASSETS if of sufficient moment should also be noted, together with such explanation as will make clear their nature. These may consist, for instance, of claims for losses sustained by breach of contract which can only be recovered by bringing suit in the courts and the outcome of which action may be too uncertain to permit of the claims being

definitely treated as an asset, or claims against the government for overcharges in duties on imports due to improper classification or excessive valuation.

THE LIABILITY SIDE.

Turning now to the liabilities, it is convenient to deal with these—as with the assets—under their various heads, and the order also follows that laid down by "Table A" of the English Companies Act.

CAPITAL.—Upon the liability side of a balance sheet, framed in accordance with the provisions noted above, the most prominent item—in the case of a corporation at least—is the stockholders' capital, which, of course, can only be increased beyond its original limit, or reduced, after due compliance with important legal technicalities. In stating the capital account, it is desirable to show first "in short" the nominal capital, *i e.*, the limit sanctioned by the Company's charter; secondly, the number and value of each class of shares issued and the amount called up thereon, from which should be deducted the amount of calls in arrear, stating the number of shares upon which such calls are due. In France, and also in South America, it is usual to state the full amount of the capital authorized as a liability, and the amount unsubscribed as an asset; but this is not at all a desirable form to adopt, as it can hardly be said that uncalled or unsubscribed capital is more than a contingent asset.

BONDS.—Next comes the amount due upon bonds, the amount extended being full amount to be paid, and the rate of interest and year of maturity should be mentioned.

Mention has already been made of the fact that at one time it was quite customary to capitalize discount on bond issues. It would, of course, be desirable that where bond discount is carried as an asset, such an item should be clearly described, but, so far as is known, it has not been the custom to state the amount of such discount in the published reports of any com-

panies except in cases where it is being written off periodically. Fortunately, the recognition of the true nature of bond discount is becoming more general and it is to be hoped that this will result in an abandonment of the practice of capitalizing it even in the case of private corporations which are not specifically forbidden to do so by governmental regulation.

The appropriate place for premiums received upon issues of either stock or bonds is in a special reserve account.

MORTGAGES.—The next item upon the balance sheet will be the amount due upon mortgages, other than those covered by bonds, and which also constitute a preferential liability, and, ordinarily speaking, are practically permanent. The rate of interest should be stated here also.

OTHER LIABILITIES.—Next come the ordinary liabilities of the company, which, according to "Table A," are separated under the following sub-headings:—

(*a*) Debts for which notes have been given.

(*b*) Debts to creditors for supplies of stock-in-trade and other articles.

(*c*) Debts for law expenses.

(*d*) Debts for interest upon bonds and other loans.

(*e*) Unclaimed dividends.

(*f*) Debts not enumerated above.

Sometimes the item "(*d*) Debts for interest upon bonds and other loans" are shown as an addition to the loans themselves. Since such interest would be covered by the same security by which the principal of the bonds may be protected, this may be the proper place for it from a legal point of view, but inasmuch as interest is a current liability as distinguished from the principal, which is a funded debt, it is preferable not to combine the two.

RESERVE FUNDS.—The next item upon the liability side is for "Reserve Fund, showing the amount set aside from profits to meet contingencies." This, perhaps, is as good a definition of a reserve fund as has been offered, and although special reserve funds may be created for the purpose of providing for special contingencies, it may be taken as an axiom that no sum which is not set aside *from profits* can properly be called a reserve fund. Nevertheless, under the heading of "Reserve" all sorts of items are frequently included which under no possible circumstances can be considered to have been set aside out of profits. This, perhaps, raises the somewhat large question as to what *are* actual profits, but it must at least be admitted that the term "Reserve Fund" is by no means applicable to all the following (although the title Reserve Account might properly be used in connection with each):

(*a*) A sum set aside to meet depreciation of property, and to provide for its future renewal. This is a charge against profits, rather than a sum set aside out of profits.

(*b*) A sum set aside for the purpose of equalizing the charge against profit and loss for repairs and replacement of machinery, &c. This, also, would appear to be a charge against profits.

(c) A reserve to provide for loss upon bad debts or depreciation of investments would likewise appear to be a charge against profits, unless, indeed, the amount so set aside was more ample than the circumstances of the case necessitated; and in this case it would probably be a better course to charge against profits what might be considered a fair reserve for loss, and to accumulate any further reserve that might be thought prudent in the form of a reserve fund pure and simple.

(*d*) Investment fluctuation account. This is an item which, unless further explained, should never appear upon the face

of a balance sheet, and that for the simple reason that its meaning is by no means clear. It may mean that investments have been re-valued at a higher figure than cost price, and the proceeds carried to this account rather than to the credit of profit and loss or reserve fund; or, on the other hand, it may mean that the investments are stated in the balance sheet at a higher figure than their actual value, and that the amount of the investment fluctuation account is an amount set aside in anticipation of future loss. The former is a perfectly legitimate form of special reserve fund; the proper place for the latter (which is, in fact, merely a depreciation account) appears to be in reduction of the stated value of the assets.

(*e*) Sinking fund, or an amount set aside (and specifically invested) for the purpose of meeting a future loss upon redemption of bonds issued at a discount, renewal of leases, &c.

(*f*) Compulsory sinking fund for the redemption or extinguishment of bonds, set aside in accordance with the provisions of the mortgage. This is a very common requirement, and is looked upon with favor by investors generally.

Some difference of opinion exists as to the proper treatment of the amounts thus raised, and the opinion of Mr. Dickinson is also of interest in this connection:

"Sinking funds or debt extinguishment funds are not in theory a charge against profit and loss, for the reason that they do not represent a loss of expense, but the extinction of an existing liability. Inasmuch, however, as in most cases the only source out of which such redemption fund can be provided is the surplus earnings, it is usual to insert a provision in trust deeds that the sinking fund is to be provided out of the profits of the year. The discharge of liabilities involves either a corresponding reduction in assets or the accumulation of other liabilities or surplus. A reduction in current assets or the accumulation of other liabilities as a substitute for bonded indebtedness is clearly undesirable and it is therefore necessary that the amount applied each year to sinking fund purposes should be transferred from Profit and Loss either to a special reserve fund or in reduction of some fixed asset account by way of provision for depreciation or otherwise. It must, however, be remembered that such provision for depreciation will be to

that extent represented by capital instead of current assets, and while there is no theoretical objection to this, if the depreciation fund is sufficiently large, the latter necessarily ceases to be available in cash for one of its principal purposes, viz., the renewal of various capital assets from time to time. If, however, part of the fixed assets are of a wasting character, the sinking fund may be quite safely applied in reduction thereof, or it may with equal propriety be applied in reduction of goodwill or patents. The safest way undoubtedly, therefore, in every case is to charge the sinking fund instalment to profit and loss each year, and either credit it to a special sinking fund reserve or apply it as depreciation of some fixed asset for the renewal of which no cash expenditure will be required in the future."

The above, no doubt, is sound reasoning, and is certainly based on conservative lines. At the same time it sometimes happens that some companies having made ample provision for depreciation, &c., do not consider it necessary to treat the payments to sinking fund as a charge against profit and loss, but simply debit "Sinking Fund" with the cash payments to the trustees. In these cases where there is no provision in the trust deed that the sinking fund shall be provided for out of profits there is no necessity to charge the amount thereof against profit and loss, and the charge may be provided for by a fresh issue of notes or capital stock.

As a rule, the trustees are not directly accountable to the company for their disposition of the cash which they receive, and can make such investments as they choose, subject in certain cases to restrictions requiring them to first purchase bonds of the same company, provided, of course, that they may be obtainable.

It seldom happens that these compulsory payments correspond in amount with proper depreciation, particularly where the sinking fund is fixed on a sliding scale, and it would not seem to be convenient to attempt to offset one by the other, nor, on the other hand, for the reasons urged above, does it seem equitable to compel a company to charge off both depreciation and sinking fund instalments.

In view of the fact that whenever sinking fund charges to profit and loss are in addition to ample charges for depreciation, probable losses on bad debts, &c., they really represent undivided profits or surplus which will revert to surplus or profit and loss account after the specific purpose for which they have been temporarily set aside (*i. e.*, the redemption of the bonds at maturity) has been fulfilled, it appears that the correct way to state the sinking fund in the balance sheet is as a separate section of the surplus or undivided profits, and not to include it among the actual liabilities.

(*g*) The "reserve" of a life assurance company, which is a fund set aside out of the surplus premiums paid by the assured in the earlier years of their insurance to meet the deficiency of such premiums to cover the increased risk of later years, when the expectation of life is shorter and which unless they are separately stated, must also provide for "deferred dividends," which are in reality actually allocated to the assured each year, but which are not payable until the expiration of the full term of the policy. To a very large extent the reserves of life assurance companies are "premiums paid in advance," rather than "accumulated profits."

There can be no doubt but that it is improper to state as a reserve fund any sum which has not been actually set aside, out of profits, *solely* for the purpose of providing against unforeseen contingencies.

It might be added that in this book the word "Fund" is, in most cases used in the same sense as many accountants use the words "Fund Account" and where investments of these items are made they are stated among the assets as "Fund Investments."

Considerable discussion of this question has taken place recently, it being contended by some that a "Fund" can only be an asset, the word itself indicating something which is tangible. The discussion, therefore, hinges largely on the interpretation of the meaning of the word, and it is hoped that

there will very soon be uniformity of opinion on the subject. At present, however, most large corporations use the word as mentioned heretofore.

THE INVESTMENT OF RESERVE FUNDS.—The numerous failures that occurred during the year 1907, and, in fact, many failures of more recent date, show that the mere existence of a large reserve fund does not in itself suffice to ward off disaster, and hence many unfortunate stockholders have bitterly stated that these paper reserves were "fictitious," and there is much truth in their contention.

The usual criticism includes a demand that reserve funds be actually invested in securities outside the business itself, and that the balance sheet show them properly "earmarked."

It cannot be too strongly advanced that the question as to whether or not any given reserve fund is represented by assets consisting of marketable securities outside the business, or by less readily marketable assets employed in the business as fixed (or working) capital, is comparatively speaking of little importance. The most casual perusal of any balance sheet will show at a glance, even to the least informed, by which class of assets the reserve fund is represented. Consequently the occasion does not arise to deal specifically with this point. What is of more importance, and what cannot be gathered usually even by the most expert accountant by a perusal of the published accounts, is whether the so-called reserve fund is (1) a *bona fide* accumulation of divisible net profits set aside (or reserved) merely to provide for unforeseen contingencies, or in general terms because it is thought inexpedient to divide profits up to the limit. (2) A reserve set aside out of profits with a view to retaining in the possession of the company assets that may hereafter be applied to a foreseen and specific purpose—as, for example, the repayment of redeemable bonds; or (3) a provision, falsely called reserve fund, set aside by charging from year to year something against profits for the purpose of building up a provision to meet a known or expected deteriora-

tion of assets in the future. No mere inspection of a majority of published accounts would enable any one to determine to which of these three classes an item described as "reserve fund" belongs; hence the extreme importance, from the auditor's point of view, of the adoption of a correct nomenclature. The term "reserve fund" without qualification, ought, it is submitted, in all cases to refer solely to class (1) mentioned above. If the reserve fund be an accumulation of divisible profits "earmarked" in advance for a specific purpose, and therefore not properly available for any other purpose (as in the case of class (2), the limitations of that reserve fund ought to be clearly stated upon the face of the balance sheet (*e. g.*, "Reserve Fund accumulated to provide for redemption of bonds in 190—," or "Reserve Fund specifically earmarked"). If a credit balance that properly comes under the definition of class (3) is called "Reserve Fund," it is submitted that the accounts are to that extent false and misleading, and that the auditor should require them to be amended, so that they may properly disclose the true position of affairs. If his reasonable requirement in this respect be refused, his only alternative would appear to be to place a certificate at the foot of the balance sheet, to the effect that his requirements, as auditor, have not been complied with in this respect—dealing, of course, fully with the subject in his report to the stockholders.

The last paragraph applies specifically to companies operating under the English Companies Acts; in view of the differences of opinion which exist in the United States as to the proper use of the words "Reserve Fund" it is considered inadvisable to advocate such a course here.

UNDIVIDED PROFITS.—The last item upon this side of the balance sheet is the balance of undivided profit. It is thought preferable to show this balance without elaboration upon the balance sheet, and in a "Profit and Loss Apportionment Account" (or the last section of the profit and loss account) to show the connection between the balance shown upon the balance sheet and the balance of the profit and loss

account for the current period. There is, however, no objection to showing the details upon the balance sheet, except that it does not appear to present the facts of the case so clearly.

CONTINGENT LIABILITIES.—With the question of contingent liabilities it is not necessary to deal at length, beyond stating that all such liabilities as are known should be noted upon the balance sheet, even if it is anticipated that they will not ultimately result in a claim against the company.

GENERAL.—It is hardly necessary to enter in detail into the forms of balance sheets required for different classes of undertakings; the same rules apply in almost all cases, and although modifications of detail will appear desirable in almost each particular case, these naturally must be considered and dealt with according to the particular circumstances that obtain, the general principle in all cases being that the accounts must not only be correct, but also so clear as to render misapprehension impossible, even among those who do not profess to be skilled accountants. In this respect it is, perhaps, well to bear in mind the particular classes of persons who are likely to be interested in the accounts. Thus, in the case of a building and loan association, lucidity will be the great thing to be aimed at; while in the case of such an institution as a bank, the main object of the balance sheet is, perhaps, less to inform stockholders as to the amount of their profits than to allow the public to form a reliable estimate upon the bank's stability. It may be added that an "account" is not primarily a collection of *figures;* it is a narration of events and facts; while a person appointed to hear and approve such narration is called an "auditor." The importance of these points lies in the circumstance that, although accounts are now written (or printed) instead of being delivered orally, the narration (or wording) is at least as material as the figures themselves.

The English Companies Act heretofore referred to indicates the accounts to which stockholders are entitled more clearly than is the case with most of our corporation laws.

The following is an extract from Table A of the act of 1908:

Section 106. Once at least in every year the directors shall lay before the company in general meeting a profit and loss account for the period since the preceding account or (in the case of the first account) since the incorporation of the company, made up to a date not more than six months before such meeting.

Section 107. A balance sheet shall be made out in every year and laid before the company in general meeting, made up to a date not more than six months before such meeting. The balance sheet shall be accompanied by a report of the directors as to the state of the company's affairs, and the amount which they recommend to be paid by way of dividend, and the amount, if any, which they propose to carry to a reserve fund.

Section 108. A copy of the balance sheet and report shall, seven days previously to the meeting, be sent to the persons entitled to receive notices of general meetings in the manner in which notices are to be given hereunder.

AUDIT.

Section 109. Auditors shall be appointed and their duties regulated in accordance with sections one hundred and twelve and one hundred and thirteen of the Companies (Consolidation) Act, 1908, or any statutory modification thereof for the time being in force.

CONSOLIDATED BALANCE SHEETS AND PROFIT AND LOSS STATEMENTS.

The proper method of stating the accounts of corporations, which are generally known as "holding" companies, has received considerable attention recently because it is believed that the omission on the part of some corporations to take up the losses of subsidiary companies, when they have included among their own earnings all the profits, has resulted in erroneous opinions as to the actual net earnings of the corporations in question.

Frequently, the balance sheet of the holding company simply gives its own assets and liabilities, and these convey practically no information at all so far as the actual condi-

tion of the subsidiary companies is concerned. In many instances very large loans to underlying companies are included in the assets. In the absence of specific information as to the separate earnings or condition of such undertaking, it is impossible to judge whether such an advance is or is not a good asset. It becomes, therefore, a grave matter of principle for the auditor to decide, and the form of the accounts in this instance becomes of unusual importance.

The opinion of A. Lowes Dickinson, F.C.A., C.P.A., on this subject, as reflected in his paper read at the St. Louis Congress of accountants, is of importance, as it is believed that the views there expressed represent the best accountancy practice:—

"During the last few years the correct statement of the earnings of a company controlling a number of subsidiary companies has required much consideration. Legally, the earnings of such a corporation consists of the results of its own operations, together with any dividends which may be declared on the stocks which it owns in the subsidiary companies; and so long as these stocks represent only minority interests in companies which are not in any way controlled or operated by the directors of the holding company, it would seem that a profit and loss account prepared in such a way would be a correct and proper statement from an accounting as well as from a legal point of view. During recent years, however, the practice of consolidating a number of concerns by a control of stock rather than by an absolute purchase of the business has grown into favor, and consequently it is usual to find the holding company owning either the whole or a large majority of the stocks of a number of companies doing a similar business, appointing the directors of these sub-companies, dictating their policy and generally acting in every way as if it absolutely owned the whole property. Under such conditions it is submitted that no statement of earnings can be considered correct which does not show in one account the profits or losses of the whole group of companies, irrespective of whether dividends have or have not been declared thereby. If this principle be not insisted upon, it is within the power of the directors of the holding company to regulate its profits according, not to facts, but to their own wishes, by distributing or withholding dividends of the subsidiary companies; or even to largely overstate the profits of the whole group by declaring large dividends in those sub-companies which have made profits, while entirely omitting to make provision for losses which have been

made by other companies in the group. It is doubtful whether there is any existing law which could legally require a corporation to make up its statement of profits on the basis here suggested, but possibly it may eventually be found that the ordinary rule referred to at the commencement of this paper, of a reasonable valuation of assets, may be made to cover this point for the following reasons:

"It is clear that whatever the value of an investment in a corporation may be at a particular date, its value at any subsequent date (other things being equal) must be greater or less by the amount of the profits or losses made during the intervening period. Even if other conditions at the two dates are not the same, and, quite apart from any consideration of the earnings or losses during the intervening period, there is a considerable appreciation or depreciation in the investment, that appreciation or depreciation must undoubtedly be more or less, respectively, by reason of profits earned or losses incurred. In this case the change in value of the asset is at any rate partly due to the result of the operations for the purpose of which the investment is held. On the general principle, therefore, that a profit and loss account should take into account all profits or losses resulting from the trading operations, but should not take into account the profits or losses arising from a revaluation of capital assets, it may eventually be held, on legal as well as on accounting principles, that the statement of earnings presented by a holding company is not correct unless it takes into account by way of either a reserve or a direct addition to or deduction from the capital value of the investment the profits or losses made in operating the subsidiary companies.

"One other difficult point is the determination of what is or is not a constituent company whose profits and losses should be brought into account in this manner. It is suggested that this depends partly on the proportion of stock owned and partly upon the degree of control exercised by the holding company. When the latter owns at least a majority of the stock, operates the company, dictates its policy and practically treats its property as its own, subject only to the right of the minority stockholders to receive a share of the profits, the conditions would appear to be such as to require the proportion of profits and losses corresponding to the stock owned to be taken up; while, on the other hand, a mere majority ownership of stock without any effective control of the management and operation might properly be treated as an investment, only subject to the same rules as other investments of a similar character."

Very little need be added to the above except that the last clause may possibly be misunderstood. It is quite correct that

its proportion of profits, only, should be taken up, but in many cases a holding company owning, say, ninety per cent. of the stock of another company, which is being operated by it in connection with other companies, should take up *all* the loss of the latter rather than its proportion only, which in this case would be ninety per cent. The reason for this is obvious. If the subsidiary company is an important or necessary link in the group usually operated by holding companies, and is losing money in its operations, it almost invariably happens that the parent company will be compelled to make cash advances sufficient to cover the losses sustained. These advances will be carried as assets by the holding company, and should be scrutinized as carefully as other accounts receivable. Obviously, advances, especially those without security, to a company whose finances are unsatisfactory or whose operations have been uniformly unprofitable, cannot be looked upon as good unless a critical examination proves this to be a fact.

If the suggestion that the entire loss be taken up in the manner advocated above is not acceptable to the directors, it might be stated in another way, viz., treat the ninety per cent. and the ten per cent. as separate items, covering the latter by charging profit and loss and crediting a reserve account in the same way that other bad or doubtful debts are treated.

Where the earnings of subsidiary companies have been carried into the books of the holding company, it follows, of course, that either some asset account, such as that representing the investment in the subsidiary company, has been correspondingly increased, or else it will be debited to an account called "Profits of Subsidiary Companies," and the holding company's current profit and loss account credited. Following out the same line where a loss has been made, the Investment Account (or any other account which represents the cost of the underlying property), or the account "Profits of Subsidiary Companies," should be correspondingly decreased and the current profit and loss account of the holding company debited.

The rule that the whole loss on operations of an underlying company must be taken up by the holding company cannot apply where the operations of the subsidiary company result in a profit. The only legitimate way by which the holding company can secure its proportion of this profit being through dividends, it follows, of course, that the minority interests, no matter how small, will receive their share, although they can never be depended upon to contribute any proportion whatever of the losses.

Where it has not been the practice to carry the results of the operations of subsidiary companies into the books of the holding company, but where a consolidated balance sheet and earnings statement is to be prepared, the latter should, for the reasons set forth, take up the entire losses of all companies where the interest is overwhelming. If this is done, there can be no objection to carrying the advances to such companies as good, but if the advances are greater than the aggregate losses taken up, great care must be taken to ascertain that the losses shown by the books of the subsidiary company are accurately determined.

Of course, this is a matter which naturally varies with the facts in each particular case. In the event of the loss being an extraordinary one, likely to be recouped in subsequent years, the question takes another aspect, as is also the case where the minority interest is considerable, and where the whole burden of advances, &c., does not fall upon the holding company.

It might be urged that if the unprofitable company is not a necessary part of the general undertaking, its operations could be suspended and further losses avoided; in such an event, if the losses on operations have, as a matter of fact, been taken care of by the holding company through its advances, the entire amount of such loss will still have to be taken up, because it cannot be assumed in such a case, any more than in a going concern, that the minority interests will contribute their share of the losses. This principle, however,

does not cover any capital loss which may ensue, and it will have to be dealt with on its merits.

A full discussion of the accounts of holding companies will be found in the paper, "The Accounting of Industrial Enterprises," by William M. Lybrand, C.P.A., reprinted in the 1908 year book of the American Association of Public Accountants, and which can be secured from the Accountancy Publishing Co.

CONCLUSION.

In considering these matters, however, it must be borne in mind that it is very exceptional for the form in which accounts are stated for the stockholders to be actually under the control of the auditor. As a rule, by-laws provide that the accounts shall be rendered in such form as the directors shall think fit, and in such cases it is, of course, impossible for the auditor to dictate as to the precise form to be adopted. This, however, does not release him from the responsibility of judging as to the fitness of the form in which the accounts are rendered by the directors. In this respect he is placed in a position and furnished with information which is withheld from the general body of the stockholders, for the express purpose of satisfying himself that the accounts submitted by the directors to the stockholders are such as will reasonably disclose the position of the company. Considerations with regard to the form which the accounts should take are frequently of a nature which the auditor must of necessity weigh for himself; for, inasmuch as the stockholders have no knowledge of the transactions or position of the company other than that which they gain from a perusal of the directors' accounts and the auditor's report, it stands to reason that if the accounts do not sufficiently disclose these things, it may frequently happen that the stockholders themselves would have no reason to suspect that the accounts were not all that they should be. It therefore follows that, although the auditor does not have the drafting of a company's accounts, it is necessary for him in all

cases to consider the form in which they are submitted for his approval, and not merely to content himself with an examination of their technical correctness. It has been stated by some that, the accounts submitted to the stockholders being the accounts of the directors, they, and they only, are responsible to the stockholders for the form. This is true to the extent that the auditor has no power to compel the directors to modify the form of their accounts; but it is not true in the sense that if the accounts submitted are, so far as they go, correct, the auditor is under no responsibility to specially report in such cases, as they are insufficient to enable any one examining them to obtain a correct idea of the company's position. Were this the case, it would indeed be difficult to see in what respect the stockholders gained by an audit of their accounts, for it is obvious that it would be possible to conceal almost anything in the shape of fraud or unjustifiable extravagance. The stockholders have, however, a clear right to such accounts as will enable them from time to time to judge of the value of their investment; and it is for the purpose of making the accounts reliable for this purpose that an auditor is appointed. And while there rests with him the serious responsibility of concealing such matters of internal detail as would, if divulged, tend to damage the position of the business, yet, on the other hand, he must not fail to remember that it is the stockholders, and not the directors, who are the masters of the fortune of the company, and that (excepting matters of internal detail) they have an undisputable right to the fullest and clearest information.

There has been a decided advance recently along the line of improved forms. It may be due to a demand on the part of stockholders, but in any event it is encouraging to those who have striven towards it for years. Appendix D to this book contains the more important standard forms now in use.

CHAPTER VIII.

WHAT ARE PROFITS?

In the preceding chapters most of the points arising in the course of an audit, with a view to ascertaining that all due precautions have been taken to test the accuracy of accounts before certifying them, have been considered in some detail; but it is advisable to review some of these various questions from the point of view of considering whether or not the amount of profit stated upon the face of the accounts is actually available for dividend. It is most important to remember in this connection, however, that until an undertaking has been actually wound up, any statement as to the profits earned is to a great extent merely an estimate, or an expression of opinion, and not a statement of facts.

ADVANTAGES OF DOUBLE ENTRY.

The reader will hardly require to be reminded that, in the case of an ordinary corporate undertaking, the amount of profit available for distribution will be represented on the balance sheet by the excess of the assets there disclosed over the liabilities and paid-up capital of the undertaking. But it is desirable for the auditor, in order to make sure of his position, to look at the matter not merely from a balance sheet point of view, but, in the first place, to carefully scrutinize the revenue account in order to see that no sources of income have been taken credit for unduly, and that all reasonable expenses have been properly debited, and then to compare the profit shown by such revenue account with the surplus before mentioned, stated to be available on the face of the balance sheet, after

scrutinizing all the assets and liabilities there disclosed. By this means he will have the advantage of looking at the matter from two points of view, which, in so difficult a question as the assessment of actual profits, is of the utmost value.

CAPITAL v. REVENUE.

It will be seen from what has been said above that, at all events economically speaking, no profits are available for distribution until provision has been made for keeping the whole of the paid-up capital of the undertaking intact. The absolute legal necessity for this provision has, however, been rendered somewhat doubtful by many decisions which have been given in the courts from time to time. The English decisions are, of course, more numerous than those which can be found reported in the United States, but in view of the fact that each case necessarily is decided on its merits, it is scarcely worth while to review all of them in this volume. The student, who may be specially interested in this branch of accountancy, however, finds much of interest in the very full law reports which are reviewed in Dicksee's "Auditing," Seventh English Edition.

It may be stated in this connection, however (although necessarily briefly and incompletely), that the effect of all these English decisions was that *under certain circumstances it might not be necessary* for a company, before declaring a dividend out if profits alleged to have been earned, to provide in that year's accounts for the whole of the loss caused by the shrinkage in intrinsic value of the whole or a portion of its assets. In one case* it is true that the actual facts disclosed did not place it beyond doubt that the fixed assets of the company were in fact less valuable than when they were taken over in the first instance; but in other cases the fact that some depreciation had occurred was undisputed, and although some provision had been made for this depreciation

* Lee v. The Neuchatel Asphalte Company, Limited (1889) (Dicksee's Auditing, Seventh English Edition, page 610).

in two reported cases,* it was not seriously contended that a sufficient sum had been written off to cover the whole of the loss.

On the other hand, it is very desirable that no undue importance should be attached to these decisions, for it must be remembered that several of the cases arose out of a motion upon the part of one or more stockholders to obtain an injunction against the directors of a company, restraining them from declaring a dividend; and that, in the absence of any evidence that creditors would be defrauded, or the rights of one or more classes of stockholders seriously prejudiced, the courts would naturally not lightly interfere with the deliberate action of the directors, endorsed by a resolution of the company passed in general meeting, in regard to a matter which would certainly appear to be essentially one of internal administration.

The most difficult questions that arise under this heading proper occur in the case of a company which has sold a part of its undertaking, but the general principles to be applied in such cases have been fairly well defined by the courts. In one English case,† it was decided that so long as it was not *ultra vires* the company, a profit made on the sale of part of the undertaking was available for dividend—upon the principle, apparently, that there was nothing in the English Companies Acts themselves to prevent a company declaring that one of the "objects" for which it was incorporated was to from time to time, as opportunity offered, sell at a profit undertakings which had in the first instance been acquired not for the purpose of re-sale, but with the idea of working them for revenue purposes. That is to say, there is no statutory provision to prevent a company from changing its mind, and deliberately converting fixed assets into floating assets. To some extent,

* Wilmer v. McNamara & Company, Limited (1895) (Dicksee's Auditing, Seventh English Edition, page 628, and Dovey v. Corey (1901) (Dicksee's Auditing, Seventh English Edition, page 767).

† Lubbock v. British Bank of South America, Limited (1892) (Dicksee's Auditing, Seventh English Edition, page 618).

however—although to no unreasonable extent—this somewhat general decision was limited by another case decided some years later.* Briefly stated, the position here was that the company had in the first instance acquired a number of miscellaneous assets for a lump sum, and had—doubtless in the exercise of a *bona fide* discretion vested in the directors—apportioned the purchase price over the various assets so acquired. One of these assets seems to have been a book debt of an extremely doubtful nature, which was valued at *nil*, but which eventually produced to the company the sum of $130,000. The directors sought to regard the *whole* of this sum as profit, doubtless on the footing that the asset in question had cost the company nothing, and that, therefore, whatever it actually realized was clear profit. On a motion on behalf of debenture-holders and a stockholder to restrain the application of these moneys to the payment of a dividend, the judge made an order in the terms applied for. In doing so, however, he said "It is clear, I think, that an appreciation in the total value of capital assets, if duly realized by sale or geting in of some portion of such assets, may be a proper case to be treated as available for purposes of dividend;" but he held—and accountants will doubtless agree with his holding—that so material a disproportion between the directors' original apportionment of the purchase-price among the assets acquired and the realizable value of one of those assets clearly suggested that, before any such alleged profit as that referred to can be safely treated as true profit, the whole business of the apportionment of the purchase-price ought to be gone over afresh. Had the directors been prepared to re-value all their fixed assets, and after such re-valuation to only treat as profit the excess of the *bona fide* value of the fixed assets retained *plus* the proceeds of assets realized, over the original cost of all assets as profit, there can, it is thought, be but little doubt that the judge would have sanctioned a dividend paid out of profits so computed.

* Foster v. The New Trinidad Lake Asphalte Company, Limited (1900) (Dicksee's Auditing, Seventh English Edition, page 754)

It is hardly likely, however, that many of the English decisions will be followed in this country, because our corporation laws are not only radically different from theirs, but usually some provision will be found in most of our statutes which bears directly on the subject. It is true, however, that most of the English decisions as to what are, or what are not, profits are based on the rules of the common law of England, and in the majority of our States the same rules or usages are followed.

The most notable American decisions along this line are those against the directors of the American Malting Co., rendered during the years of 1903 and 1904, which not only attracted attention from the fact that the directors were compelled to pay back to the company something in excess of one million dollars but they were also of interest on account of the accountancy principles involved.

One of the cases arose in the New Jersey courts, and one in New York. The latter is fully reported in Appendix "C." The following brief résumé of the principal points in the New Jersey decision appears properly at this point.

APPLETON v. AMERICAN MALTING CO. 65 New Jersey Equity, page 375. Court of Errors and Appeals New Jersey. March 11, 1903. Section 30 of the Corporation Act of New Jersey provides as follows:

"No corporation shall make dividends, except from the surplus or net profits arising from its business, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this act, and in case of any violation of the provisions of this section, the directors under whose administration the same may happen shall be jointly and severally liable, at any time within six years after paying such dividend, to the corporation and its creditors, in the event of its dissolution or insolvency, to the full amount of the dividend made or capital stock so divided, withdrawn, paid out or reduced, with interest on the same from the time such liability accrued: provided, that any director who may have been absent when the same was done, or who may have dissented from the act or resolution by which the same

was done, may exonerate himself from such liability by causing his dissent to be entered at large on the minutes of the directors, at the time the same was done, or forthwith after he shall have notice of the same, and by causing a true copy of said dissent to be published, within two weeks after the same shall have been so entered, in a newspaper published in the county where the corporation has its principal office."

Certain directors of the AMERICAN MALTING COMPANY voted for dividends which were paid out of capital in violation of the above statute.

Thereupon certain stockholders filed a bill in equity to compel the directors of the company to pay back said dividends into the treasury of the company.

The directors contended that they were liable only in case of the dissolution or insolvency of the company, and that as their conduct had not resulted in either the dissolution or the insolvency of the company, they were not liable.

The court, however, held them liable, delivering the following opinion:

"It is argued by the demurrants (directors), as has been already stated, that the statute, so construed, is grossly unjust and inequitable, in that it requires the directors to pay into the treasury of the corporation, for the benefit of the stockholders, the amount of the deficit, although the stockholders, not the directors, have in their pockets the portion of the capital which has been withdrawn. The argument assumes that there will be no transfer of the stock of the company during the period of the liability of the directors. The assumption is unwarranted. The very declaration of the dividend, evidencing, as it does, the apparent prosperity of the company, creates a desire on the part of outsiders to become holders of the stock. It, at the same time, decreases the actual, while increasing the apparent, value of the stock. The result is to afford unscrupulous directors, and stockholders who are cognizant of the illegal action of the board, an opportunity to unload their holdings upon innocent purchasers at fraudulently inflated prices. It is eminently just that the persons, whose wrongful act has caused loss to those who have been induced by it to become stockholders, should make good that loss, but is it inequitable that stockholders who have innocently participated in the distribution of the illegal dividends should have their stock restored to its normal value by contribution from the directors who have impaired the capital, without

being first required to pay back the dividend so paid to them? The ordinary purchaser of corporate stock holds it as an investment. He rightly considers and treats the dividends paid upon it as income. In many instances the income is required to meet the expenses of living, and is entirely expended for that purpose. To say that a person who has been unwittingly induced to exhaust his principal, by the mistaken or fraudulent representation of those to whom he has entrusted it that what has been paid to him as income, suffers no injury, is absurd. To refuse him redress, except upon condition that he return the moneys which he has expended in the belief that his capital was intact—notwithstanding that by such expenditure he is rendered penniless is to put a premium upon fraud in corporate management."

From the auditor's standpoint the New York decision is of far greater importance, and the entire text is well worth reading.

It should be noted that the New Jersey law (already quoted) requiring dividends to be paid only from profits, is similar to the New York statute. Section 23 of the (New York) Stock Corporation Law provides:

"The directors of a stock corporation shall not make dividends, except from the surplus profits arising from the business of such corporation; nor divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital of such corporation, or reduce its capital stock, except as authorized by law. In case of any violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes of such directors at the time, or were not present when the same happened, shall jointly and severally be liable to such corporation and to the creditors thereof to the full amount of the capital of such corporation so divided, withdrawn, paid out or reduced."

The court in passing on the question of "What are Net Profits?" quotes the following definition from the Century Dictionary: "What remains as the clear gain of any business after deducting the capital invested in the business, the expenses incurred in its management and the losses sustained by its operation."

It will be noted that the main controversy in the case arose over the question as to whether the company had a right to declare dividends from book profits which were largely, if not wholly, anticipated. Referring to this point the court said:

"To calculate months in advance on the result of the future transactions, and on such calculations to declare dividends, was to base such dividends on paper profits—hoped for profits, future profits—and not upon the surplus or net profits required by law. It does not seem to me that you can 'divide,' that is, make a dividend of a hope based on an expectation of a future delivery at a favorable price of what is not yet in existence, under the statute," and further on: "It does not seem to me that in these days of great corporations and of combinations into one of many corporations it is asking too much of directors, fiduciary officers as they are, that they should obey the law of their incorporation and not bring their companies to the verge of bankruptcy and ruin by the payment of quarterly dividends on preferred stock out of capital instead of net earnings."

It might be added that, although the company had made no allowance for depreciation, the point was not raised by the plaintiffs, and the court was, therefore, not called upon to pass upon it.

The English Companies (Consolidation) Act, 1908 (8 Edw. 7, Ch. 69), contains the following provisions with respect to dividends and reserves.

DIVIDENDS AND RESERVE.

TABLE A.—Section 95. The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the directors.

Section 96. The directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company.

Section 97. No dividend shall be paid otherwise than out of profits.

Section 98. Subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid on the shares, but if and so long as nothing is paid up on any of the shares in the company, dividends may be declared and paid according to the amounts of the shares. No

amount paid on a share in advance of calls shall, while carrying interest, be treated for the purposes of this article as paid on the share.

Section 99. The directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies, or for equalizing dividends, or for any other purpose to which the profits of the company may be properly applied, and, pending such application, may, at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company) as the directors may from time to time think fit.

Section 100. If several persons are registered as joint holders of any share, any one of them may give effectual receipts for any dividend payable on the share.

Section 101. Notice of any dividend that may have been declared shall be given in manner hereinafter mentioned to the persons entitled to share therein.

Section 102. No dividend shall bear interest against the company.

DEFINITION OF "PROFITS."

In connection with the question as to what are "profits available for distribution," it is of interest to note the definition given in *Buckley,* 8th Edition, pages 584 and 585, which is as follows:

"The profits of the business of the company are the credit balance of a profit and loss account properly prepared, having regard to the definition of the business in the memorandum of association. They are the excess of revenue receipts over expenses properly chargeable to revenue account. As to what expenses are properly chargeable to capital and what to revenue it is necessarily impossible to lay down any general rule. In many cases it may be for the shareholders to determine this for themselves provided the determination be honest and within legal limits."

It will probably be admitted that this is one of the most diplomatic definitions that has ever been given upon a subject of such vast importance; inasmuch as it leaves the inquirer exactly where he started, for it still remains for him to define what receipts are apportionable to capital and what to revenue,

and what expenses are chargeable to capital and what to revenue. Could these questions be definitely answered in each case, it is obvious that the question of what the actual profits have been would be one capable of the most ready solution. In view of the close relation of the whole subject of "profits" to the decisions of the courts it becomes necessary to ascertain the legal meaning of the word. In many undertakings the judgment of the professional auditor as to the question of actual profits may differ from most lawyers but it is nevertheless important to have in mind all that may be said on the subject by competent authorities, and the following extract from a leading law text-book (Cook on Corporations. 5th Edition, page 1164) is therefore in order:—

"In view of the rule that dividends can be made only from profits, it becomes important to ascertain what part of the income of a corporation constitutes 'profits' which may be used for a dividend. This question has caused the courts considerable difficulty. There have been various definitions, explanations, and different states of fact involved in the cases which have come before the courts. The Supreme Court of the United States has said that 'the term "profits" out of which dividends alone can properly be declared, denotes what remains after defraying every expense, including loans falling due, as well as interest on such loans.' An English court says that profits are 'the excess of the current gains over the working expenses as shown by revenue accounts as distinguished from capital accounts.' A clear idea of what constitutes profits available for dividends can be obtained only by a study of the cases themselves.

"There are some general principles connected with this subject which have been established by the adjudications. It is not necessary for a railroad or other corporation to use its profits to pay its funded or bonded debt instead of using those profits for a dividend. But it is necessary to pay the interest on such bonded debt before any dividend is declared.

"The floating debt should be paid or funded before a dividend is declared. A corporation often owes large debts and still has its capital stock intact. So also outstanding and disputed claims need not be first paid.

"A proper sum must first be expended or set aside for repairs and reconstruction to replace depreciation due to wear and tear. In other words, the fund available for dividends is ascertained by taking

into account the cost of repairs and a reasonable allowance for depreciation, giving credit for all actual permanent improvements. But in the case of a company owning patent rights, or of a mining company whose product when once used can never be replaced, it is not necessary to set aside funds for the purpose of purchasing new patents or a new mine.

"In estimating the profits for a year for the purpose of declaring a dividend, it is not necessary to take into account the decrease in the value of the assets and the impairment of the capital stock of the company prior to that year. The fact that in a year prior to the declaration of the dividend some portion of the capital has been lost and has not since been made good affords no ground for restraining the payment of a dividend out of profits subsequently earned. A corporation 'which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost.' Thus, although a mining company for several years is obliged to pay the interest on its debts out of the capital stock, nevertheless in subsequent years, when large profits are earned, it may use such profits for dividends in any year after paying the interest on the debt for that year. The company need not first restore the capital stock.

"In Connecticut it is held that dividends may be declared on preferred stock where the net earnings since the issue of the stock are sufficient, even though prior to such issue the capital stock had been impaired, but that ordinarily, in declaring dividends, the directors are not justified in assuming that the value of property which was originally received in payment for stock is still worth that value, and if such property at the time of the dividend was not actually worth the par value of the stock which was issued for it, the dividend is illegal, and a director receiving such dividend as a stockholder may be compelled to pay it back at the instance of a receiver of the corporation. This rule is, of course, subject to statutory restrictions, as, for instance in New York State, where dividends can be made only from 'surplus profits.' A dividend may be declared, although the company has not yet completed its works. In the case of railroads, the cost of additional rolling stock and improvements may be charged to capital account, and need not be paid before a dividend is declared. Where one company buys out another and agrees to pay a certain salary to an officer of the latter, or a lump sum in lieu thereof, such lump sum, if paid, is a part of the capital stock, and need not be considered as expenses.

"Insurance companies cannot declare dividends out of unearned premiums. Banks cannot declare dividends out of interest not yet

received. The question of what constitutes profits applicable to dividends arises often in connection with preferred stock."

Another legal opinion is that in *Richardson v. Buhl,* 77 Mich., 632 (1889), the court approving of the following statement:—"That the first thing to be done by any manufacturer, who would ascertain his net earnings during the preceding year, is to take a careful inventory of what he has left, including his plant and machinery, and then make just and full allowances for all losses and shrinkages of every kind that he has suffered in his property during the year, and for all expenses of every kind, ordinary or extraordinary, that have occurred during the year; and, having made such inventory, and deducted such losses and shrinkage of every kind, his net earnings will be the difference between all his investments in his business and all his expenses of every kind on the one hand, and this new inventory, with the deductions properly made, and all that he has received of every kind, on the other hand; and if his books are properly kept and proper deductions made, these net earnings will finally appear on the balance sheet to the credit of the profit-and-loss account."

The foregoing opinions are exceedingly interesting, and with the exception of a few of the statements made, correspond very closely with the rules followed by the best American practitioners.

The reference to the necessity for charging depreciation before ascertaining profits available for dividends should be noted, and it would not be out of place for an auditor to quote from the opinions of the court when reporting to the board of directors of a company who have shown a disposition to ignore the question of depreciation.

It would seem to be clearly set forth in the law books and some of the opinions (even if not specifically stated) that depreciation *must* be provided for in ordinary undertakings before the fund available for dividend can be stated, and in view of the decisions in the "MALTING" case (as bearing upon the

necessity of profits being actually earned before dividends can be paid) reference thereto might effect a change in the minds of some directors, more particularly with respect to New York and New Jersey corporations.

REVENUE RECEIPTS.

These somewhat exceptional points being thus disposed of, the right conception of the effect of more ordinary transactions may now be considered. For this purpose it will be convenient to classify the various items appearing upon both sides of a revenue account, which in the aggregate show the profit alleged to be available for dividend. Upon the credit side these items may be conveniently classified under the following headings:—

(*a*) Profit on transactions completed but not yet received in cash.

(*b*) Profit on transactions not completed, whether received in cash or not.

(*c*) Profit on transactions completed and received in cash.

(*d*) Profit arising from an estimated rise in the value of fixed or floating assets.

(*e*) Profit not properly incidental to the nature of the business carried on.

With regard to (*a*) it is hardly necessary to add to what has been already said in the preceding chapters, but the principles there enunciated may be summarized as follows:

It is necessary to consider

(1) Whether it may be fairly and reasonably anticipated that the debt will be discharged in due course.

(2) Whether any allowance or discount is likely to be claimed when the debt is discharged; and

(3) Whether it is necessary to allow for the loss of interest incidental to the deferred payment of such debt.

The points which arise on (*b*) have already been very fully considered under the headings of "Work in Progress" and "Goods Sold for Future Delivery." It is, therefore, unnecessary to go further into detail in the present chapter. It may be added, however, that, in the case of financial companies underwriting issues of shares or bonds, it would appear to be clearly improper to take credit as a profit for any commission upon such underwriting in respect of that portion of the issue which had been allotted to—and still remained in the hands of—the company by reason of the subscriptions from the general public being insufficient. The nature of an underwriting agreement is that, in consideration of a certain commission, the underwriter agrees to take a certain portion of the issue if the public do not subscribe enough among them to take up the whole amount among themselves. In the event of the public subscriptions being insufficient, therefore, the contract has the effect of the underwriter acquiring a certain portion of the issue at a discount; and that is the view which, it is submitted, the auditor should take of the transaction. If this view be adopted, it necessarily follows that until such shares or bonds are disposed of they should appear as an asset in the accounts of the underwriter, not at their face value, but at cost price; that is to say, the underwriting commission should be dealt with, not as a profit, but as a reduction from the actual cost of the shares or debentures, as the case may be. *A fortiori* if assets are sold for payment in "paper," no profit should be taken credit for until that paper is actually realized in cash.

(*d*) Although it was held in one English case and is the opinion of some of the most prominent American lawyers that a company may take credit for an assumed rise in the value of its floating assets, should it think it expedient so to do, it is thought that accountants, as a body, will be more inclined to take the view that any profit arising in respect of dealing in such assets should only be taken credit for in the period during which such dealing actually occurs. That is to say, assuming that such floating assets have risen in value, the

proper time to take credit for the profit is not when the rise may in point of fact have occurred, but at the time when such assets are sold.

The views referred to above, however, do not apply to an assumed appreciation in the value of *fixed* assets, and it need not be urged that good practice would never permit taking credit for the apparent profit so arising.

Full consideration of this point would, however, appear to be more conveniently dealt with under the following heading:

(*e*) In some undertakings it may happen that earnings may airse from unusual transactions, and the question, therefore, arises as to the proper treatment of these earnings.

Leaving upon one side the most usual source of profit of this description—viz., the sale of a portion of the company's undertaking—which has already been dealt with, the most ordinary classes of profits to come under this heading would be premiums received upon stocks or bonds, and cash which has been paid on shares forfeited. The usual custom with both these sources of profits is to credit the amount to reserve fund, and it would be difficult to improve upon this. But, at the same time, it has already been pointed out that—in the absence of special by-laws, and in the absence of a by-law specially so providing—there is nothing to prevent a company transferring the whole, or a portion, of its reserve fund to profit and loss account, and declaring a dividend out of the increased balance so available.

REVENUE EXPENSES.

Turning now to the expenses recorded upon the debit side of the revenue account, these may be conveniently classified under the following headings:—

(*a*) Expenses that are properly chargeable to the period under review.

(*b*) Expenses which may properly be spread over a term of years.

(*c*) Undisclosed and contingent liabilities.

(*d*) Depreciation.

(*e*) Losses arising by fluctuation of current assets.

(*f*) Losses arising by fluctuation of fixed assets.

(*g*) Reserves for losses.

(*h*) Preliminary expenses.

With regard to (*a*), it is obvious that these amounts should all be charged up against the current year's revenue, and the steps which have been indicated in the preceding chapters should be taken to see that everything coming under this heading has been so charged.

(*b*) It should be remembered that the onus rests upon the directors and auditor to justify this class of expenditure *not* being included as a charge against the current profits, and that the auditor must therefore, before passing the accounts, satisfy himself as to the sufficiency of the reasons advanced for its exclusion. Examples of items which may be properly held in suspense are dead rents paid in excess of royalties by colleries and similar undertakings where there is reasonable ground for supposing that they can be redeemed out of future earnings, and also special expenditure in the way of advertising some new venture or undertaking, which expenditure, it is estimated, need not be maintained after the venture has been once established. With regard to the latter, however, especial care is necessary, with a view to seeing that a sufficient sum is written off annually, as it not infrequently happens that the expectations of the managers are not realized, and that the permanent cost of advertising is far more than has been anticipated.

A decided stand should be made against any distribution over future years of ordinary operating expenses merely be-

cause they may be of unusual amount. If the accounts of a street railway, for instance, have been kept without making any provision for depreciation of plant, and the time finally arrives, as it is bound to do, when it is necessary to make extensive renewals, it is manifestly improper to carry forward any part of the cost of such renewals. It is obvious that the renewals are due to past operations—which should have been charged at the proper time with the expense eventually to be caused thereby—and have no connection whatever with future operations. The foregoing statements do not apply to such portion of the cost of renewals or replacements as might represent an improvement in type or increased capacity above that of the construction replaced; such portion of the cost could quite properly be carried forward.

Nor would it be proper—to use another illustration—in the event of a disastrous accident which entailed extraordinary large disbursements for damages, to carry forward as a deferred charge a portion of such disbursements merely because they were much larger than usual and would consequently disturb the continuity of the results ordinarily shown. As the accident is an incident in the period's operations if a sufficient reserve to provide therefor does not exist, the income of the period must be charged with the expense caused thereby and it is hardly necessary to add that a dividend could not be properly declared on the basis of an income account which omitted to charge a considerable sum actually disbursed, or for which the corporation is liable, for damages incident to operation.

It is unnecessary to add anything upon either (*c*) or (*d*) to what has already been said in the preceding chapters, where both matters have already been very fully dealt with.

Passing on to (*e*), it may be pointed out that, inasmuch as the definition of "current assets" is that class of assets which it is the object of the undertaking to convert with all convenient speed into cash, it is obvious that, so far as possible, nothing in excess of the actual current market value should be

attached thereto upon the face of any balance sheet, and the conservative rule, "cost or market, whichever is the lower," followed. Special circumstances may occasionally modify this, where at the moment of balancing there has been a wholly unexpected and *temporary* fall in value which has been recovered before the certifying of the accounts. It is probable, however, that it is only in connection with the treatment of foreign exchanges that this principle can generally be safely applied.

(*f*) Concerning this item, it is thought that, so long as the permanent earning capacity of the fixed asset has not diminished, it is quite unnecessary for any provision to be set aside, with a view to making good a loss which may have occurred by reason of the fluctuation of the value of such assets. Certainly the legal decisions which have been given in England under similar circumstances would appear to support this view, and the quotation from "Cook on Corporations" also bears it out. It is important to remember, however, that if the views already expressed with regard to fluctuations *upwards* in fixed assets have been disregarded and credit has been taken for such fluctuations as a profit, then *a fortiori* it is necessary that fluctuations downwards should be given effect to.

(*g*) With regard to reserves for losses, as has already been pointed out, it is very important that ample reserves should be made to meet all reasonable contingencies before allocating profit for purposes of payment of dividend. The only thing that appears to call for attention here is that in some cases —although, of course, quite improperly—what is really a reserve against loss is described upon the face of a balance sheet as a "Reserve Fund"; under no circumstances, however, must such so-called reserve fund be encroached upon for the purpose of equalizing dividends, unless the auditor is satisfied that a sufficient balance remains to meet any reasonable expectation of loss that may occur.

(*h*) Under almost all circumstances it will be found usual to write off a portion of the amount incurred by a company in preliminary expenses say, one-third or one-fifth, in each year's accounts until the amount is wholly extinguished. There is no compulsion, however, that this course should be adopted, although it is certainly one to be recommended; and it may be added that, should the first year's accounts show a loss, it is distinctly preferable not to obscure the actual facts of the case by increasing such loss by writing off any portion of the preliminary expenses. It is, of course, impossible to write them off except out of profits, and the attempt should, therefore, not be made upon paper. *Per contra,* where there is a reserve fund and the accounts for the current period show a loss, a transfer of such loss should be made to the debit of reserve fund, so far as the latter is sufficient for the purpose, it being a contradiction in terms to state a loss upon one side of the balance sheet and a reserve fund (*i. e.,* an accumulation of undivided profits) upon the other side.

In Conclusion, it may be pointed out that although the "cash" basis, as applied to commercial accounts, is in the nature of things most fallible, it has a very substantial utility, as applied to the revision of the results arrived at by means of the ordinary revenue account. The primary object of every revenue account is, of course, to arrive at the true net profit earned during the period under review; but, in the case of the vast majority of undertakings, by no means the least important use to which the revenue account will be put is to determine the amount of such profits *available to be drawn out of the business* and distributed among the proprietors in the case of a company or a partnership, or spent by the sole proprietor in the case of a business owned by an individual. The terms "net profit" and "profit safely divisible" are by no means interchangeable; for unless the working capital be abundant, profits cannot be prudently drawn out of the business until they have been actually realized in cash. It therefore follows that, in the great majority of cases, a safeguard—and

at the same time an easily applied rough check upon the accuracy of the revenue account—is afforded by looking at the balance sheet, and seeing whether it would be practicable to draw out of the business the whole of the profits alleged to have been made, and whether there would then still remain a sufficient balance of "liquid" assets available to meet the ordinary requirements of the business. Unless such a sufficiency would remain after dividing profits up to the hilt, it is clear that such profits have not been realized, or else that they have been diverted from their proper course and applied as working capital, in either of which events it would be impossible to distribute them without causing financial embarrassment.

CHAPTER IX.

THE ATTITUDE OF THE AUDITOR.

In the foregoing chapters the object, extent and manner of conducting an audit have been dealt with, and also—so far as the space at disposal permitted, and the general scope of this work appeared to justify—such modifications of and departures from, the normal plan as are necessary to adapt it to the peculiar requirements of any individual audit with which the reader is likely to be concerned. The position of the auditor himself will now be more particularly considered.

WHO MAY BE AN AUDITOR.

Auditors may, for general purposes, be divided into three classes.

(*a*) Amateur auditors.

(*b*) Professional auditors.

(*c*) Official auditors.

It may be well to say a few words about each class before proceeding further.

AMATEUR AUDITORS are a class to whom the author has no great desire to express either affection or respect. He has seen too much of their shortcomings, and of the inexpressible misery and distress that have been caused by their scandalous incompetency, to feel any desire to deal gently with their failings. Auditing is much too serious a matter to be trifled with; the evil that can be wrought by an incompetent auditor is hardly less vital—and is infinitely more extensive

—than that which may be exercised by an unqualified medical practitioner. The latter, if he be the possessor of an extensive practice, might possibly poison a hundred or so patients in the course of a long career; but the former can, while merely confining his attentions to the affairs of one undertaking, readily accomplish the ruin of thousands and the starvation or suicide of scores in a much shorter period.

Some may think that is overstating the case, and will say that there are many amateur auditors who are both capable and conscientious. It is not attempted to dispute the fact that the number of amateur auditors who are known to have failed to justify the confidence reposed in them is altogether insignificant as compared with the number who are still discharging their functions to the satisfaction of all concerned. It may, however, be remarked that "the satisfaction of all concerned" does not go for much; the auditors of a host of disastrous undertakings in Great Britain and the United States exercised their functions, presumably, "to the satisfaction of all concerned" (especially of the criminals) until the moment when the crash occurred; and it is worthy of note that the crash never does occur until the defalcator has taxed his milch-cow beyond its strength, and that when it does occur, it is not the amateur auditor who has brought it about. In fact, until the defaulter is fool enough to kill his golden goose, the amateur auditor always does "continue to discharge his functions to the satisfaction of all concerned"; but does that prove the said auditor to be discharging his functions either capably or conscientiously? Assuredly not.

Again, is it not a fact that, as a class, amateur auditors have been shown (by indisputable statistics) to be more often concerned in cases of disaster than professional auditors? Is it not almost invariably the case that, where professional auditors are concerned, they have themselves detected the frauds, while with the amateur auditors the crash almost invariably comes from without?

As, however, this work is primarily intended for the use of professional auditors—to whom, alone, the perusal of any book upon auditing would be likely to confer any practical advantage—the subject need hardly be pursued further. It is of interest, however, to note that, while the number of amateur auditors in England is said to be thinning down each year, we are not justified at present in making a similar assertion to cover the United States.

The American Association of Public Accountants, which includes in its membership practically all the professional accountants in the United States, does not yet number one thousand members, while the British societies number at least seven thousand members.

When we consider the vast number of corporations, beneficial organizations, savings banks, building and loan societies, and other undertakings where the accounts are submitted each year to "auditors," and when we consider further that the surety companies before renewing the bonds of employees require a certificate to the effect that the accounts have been examined, we gain some idea of the tremendous aggregate of amateur auditing which is being done at the present time. The appalling number of defalcations occurring annually may be traced largely to the fact that the audits conducted by committees of stockholders or members are not only incomplete, but the very fact that the defaulter knows exactly how (little) his accounts will be investigated gives him such a feeling of security in his manipulations that he becomes more daring and abstracts larger sums than if no audit were expected.

As was stated by an English accountant in this connection "the gentlemen appointed have not either the time, the inclination or, so to speak, the machinery, for that thorough examination which we know to be essential if an audit is to be effectual and reliable." Constant agitation of the inefficiency of amateur auditors will do much to draw the attention of the business public to the danger of employing them. In justice

to the amateur, however, it must be said that his duties are frequently thrust upon him, and many of them would gladly surrender their nominal positions of honor to more capable hands. Many substitutions of professional auditors have been at the direct solicitation of the amateurs, so that it is hoped that by a simple process of elimination the good ones will soon go of their own accord and the bad ones will be superseded.

Steps in this direction have been taken by many corporations and societies through the introduction of a clause in their by-laws requiring the employment of *Certified Public Accountants,* and the day is probably not far distant when the omission of such a requirement will be the subject of unfavorable comment by the investing public. It is believed that the controlling spirits in our corporations and societies are becoming sensitive enough on this point to warrant the hope that the practice suggested will become general in a short while.

PROFESSIONAL AUDITORS are a class with whom the reader may fairly be considered to be well acquainted. Both on account of their special training and on account of the fact that their energies are not distracted by other, and dissimilar, occupations, they are *par excellence* the ideal auditors. Moreover, the peculiar facilities they possess, in the shape of a large staff of specially trained assistants, place them in the position to thoroughly perform audits of a magnitude that could not conscientiously be undertaken by any one man, no matter how skilled.

On the other hand, it is only fair to state that while an audit, conducted by competent and responsible professional accountants, is the only form of audit that can reasonably be expected to provide those safeguards which every audit ought to secure, there are some, even among the ranks of professional accountants, whose chief anxiety appears to be to disclaim any such measure of responsibility for their work. Thus it has been asserted in one quarter that " he is the worst friend

of the (accountancy) profession who seeks to enlarge the responsibilities of auditors"; while the index of the Eighth Edition of "Auditors, their Duties and Responsibilities," by Mr. F. W. Pixley, F.C.A., does not comprise any such words as "Defalcations," "Fraud," or "Liabilities of Auditors"—thus clearly showing that, although these matters may be dealt with incidentally in the body of the work, they are regarded as of quite second-rate importance.

It is quite clear that under no circumstances can any professional audit be regarded as so complete a safeguard as to constitute, in effect, an "insurance" against fraud, and it has been expressly held by the English Court of Appeal that an auditor "is not an insurer." There is, however, a vast difference between holding an auditor liable as an insurer and expecting him to provide such reasonable safeguards as will, under normal circumstances, preserve the undertaking against loss owing to dishonesty. Dealing with the matter first of all from the purely commercial—and therefore from the lowest possible—standpoint, the minimum premium charged by an insurance company for a guarantee of honesty is thirty cents per hundred dollars, and a higher premium is almost invariably charged in the case of employees. A comparison of this figure with most audit fees will show that, if any credit at all is to be given for the actual work of examining the accounts (which work is, of course, never performed by a guarantee insurance company), little, if anything, remains to cover an "insurance" of the honesty of the staff; while a slightly broader—and, therefore, more common-sense—view of the situation must, of course, show that the risks which insurance companies, with their large paid-up capitals, can afford to run in the ordinary course of their business are far different from the risks that any individual professional man could prudently accept. Thus, on the grounds of law, equity, and expediency alike, it is clear that an auditor does not guarantee his client against all loss by dishonesty. This, however, is, it need perhaps hardly be pointed out, a very different thing indeed from

an entire disclaimer of all pecuniary responsibility. The mere fact of an auditor attaching his signature to the accounts of an undertaking, *qua* auditor, is a distinct "representation" to all whom it may concern that the accounts in question have been audited by him; and all, therefore, who are entitled to rely upon this representation are clearly entitled to the assurance (using the word in its popular sense) that the work alleged to have been performed has been conducted with a reasonable amount of skill and care. The exact effect of this "assurance" in each separate case must, of course, be determined upon the merits of that case; but the safeguard afforded by this personal responsibility of the auditor is, in itself, by no means a negligible quantity. Further, it may be pointed out that, in the case of professional auditors, whose living depends upon their reputation for skill and care, a far greater measure of security is provided than the mere legal limit of the responsibility of the auditor. For obvious reasons it would be inexpedient to strain this legal responsibility too far, or the effect would inevitably be to drive men of substance out of the profession; the chief safeguard of a professional audit, and its great superiority over an amateur audit, lies thus not in any increased measure of legal responsibility (for the law recognizes no distinction between professionals and amateurs), but in the safeguard afforded by the fact that the professional depends for his livelihood on his business reputation as a careful and skilful auditor, whereas the amateur obviously does not. At the same time the efforts that have been made in some quarters to reduce the legal responsibilities of auditors to "vanishing point" cannot be too strongly deprecated.

OFFICIAL AUDITORS are a class that need not be considered here at any great length—the author's sole object being to produce a work of practical utility to the profession.

The term "official auditors" as used here includes all those who are employed to audit the accounts of state and municipal authorities, as well as those appointed by the courts of

the various states to examine and pass upon the accounts of decedents' estate, &c. The latter are almost invariably lawyers, and the most important part of their duty appears to be to scrutinize the various transactions, with a view to seeing that they are not *ultra vires*. This is, of course, a very important matter, but it is to be regretted that the attention of official auditors should be—as in point of fact it is—almost entirely restricted to a scrutiny of the accounts from this point of view, with the result that, although the accounts are supposed to be checked with a view to detecting error and fraud, it has frequently transpired that dishonesty has remained undiscovered for a very considerable period, and that the accounts themselves are grossly inaccurate in essential particulars. It is suggested that, for the accounts of estates, &c., to be really effectively audited, the investigation of the official auditors, with their legal training, should be confined to a scrutiny of the various transactions from this point of view, the actual verification of the accounts themselves being performed by professional auditors, who by their training are far better qualified than any lawyer to detect both errors in accounting and dishonesty on the part of those having the handling of money. This, it is thought, is the true solution of the difficulty; but, because these matters are frequently settled on party lines, and rarely on their merits, it is not likely to be adopted.

Still another class of official auditors includes various employees of national and state departments who almost invariably secure their positions through political influence, but upon whom devolves a vast amount of work which more properly belongs to professional auditors. It is altogether likely that the inefficiency of many of these men will lead to reforms in this direction which cannot help increasing the scope and responsibility of the work of the *Certified Public Accountant*.

It must be taken into consideration, however, that official auditors usually work under disadvantages in that they are not only limited as to the scope of their examinations, but, fur-

thermore, the time at their disposal is ordinarily too limited to admit of a thorough audit in most cases.

A case in point is that of one of our large insurance companies, having over four hundred millions of assets, which had been "audited" regularly by the "Auditors" of the State Insurance Department, whose report had uniformly been favorable. Disclosures of gross irregularities from within occasioned a more searching examination on the part of a committee of directors, as well as an additional examination by the State Department. Both of these, however, proved ineffectual, and, common-sense finally prevailing, two leading firms of Certified Public Accountants were engaged, and a general feeling immediately prevailed that the actual condition of the company in question would at last be ascertained.

The more prominent of the official auditors included in the last class include National, State and Clearing House Bank Examiners, State Auditors employed by the Departments of Insurance, Charities, &c., and Examiners connected with the Bureau of Corporations of the Department of Commerce and Labor.

In recent years there has been a strong tendency towards Government supervision, with the consequence that the number of "official" auditors has greatly increased, and in all likelihood the accessions to the ranks will continue. It is not proposed to criticise nor even discuss the work done by these officials, but it is not out of place to call attention to the fact that the salaries attached to the positions are, for the most part, considerably too low to attract first-class men.

There are, therefore, two reasons at least why official auditors are not so competent as professional auditors, one being the fact that many of the appointments are in payment of political debts, with the consequent result that wholly inexperienced and incompetent men are frequently chosen; and, secondly, even if the places were filled solely upon the basis of merit, it is not to be expected that capable men will be found,

in any great number at least, occupying positions of great responsibility but with small salaries attached.

THE AUDITOR'S QUALIFICATIONS.

Upon this point a considerable quantity of professional literature already exists. The subject has been touched upon in a great number of addresses and magazine articles. It is not, therefore, proposed to consider the subject at any great length (for, there being no essential difference of opinion upon the matter, such a course appears to be uncalled for), but rather to briefly indicate the qualities that go to make an efficient and a successful auditor.

First, then, it is very generally conceded that an exhaustive knowledge of every department of bookkeeping is the very "A B C" of the auditor's art.

Second in importance, probably, is a thorough acquaintance with various statutes regulating the different undertakings in which the auditor may be concerned.

Thirdly, although this point has been bitterly contested by some, a sufficient knowledge, not only of business generally, but of the especial way in which various particular businesses are conducted. As was expressed by an English accountant some years ago: "No accountant can successfully carry on his practice in all the above-mentioned branches unless he is a person of considerable knowledge, skill, and experience, for he must be not only acquainted with bookkeeping, which is to him as the alphabet only; but, to put it very briefly, he must have some general knowledge of various trades and their customs. . . . He ought also to have some knowledge of the practice of the Stock Exchange," and so on. No unprejudiced person would deny the advantage of such a knowledge as is here advocated; the only question being whether the standard set is so high as to be virtually unattainable, and, consequently, impracticable. The reply to this is that, in accountancy, as elsewhere, it is only he who

aims at absolute perfection who can expect to attain even to a decent mediocrity. A complete knowledge of everything is not readily attained in threescore years and ten, and is not expected as the result of the limited period of study preceding the various State examinations. Only let the accountant make the most of his opportunities—and he will find that his general practice, as well as audits, will afford him many—and he will be surprised at the amount of knowledge he can acquire, even in a short time, and perhaps even more astonished at the vast amount of service such knowledge will be to him in his profession.

Lastly, but not least, may be placed those desirable qualifications of the auditor which are not acquired by careful study, but, rather, by *living*. Tact, caution, firmness, fairness, good temper, courage, integrity, discretion, industry, judgment, patience, clear-headedness and reliability. In short, all those qualities that go to make a good business man contribute to the making of a good accountant; while that judicious and liberal education which is involved in the single word "culture" is most essential for all who would excel. Accountancy is a profession calling for a width and variety of knowledge to which no man has yet set the limit; the foremost accountants are not ashamed to say that, like Epaminondas, they "learn something in addition every day"; let us, therefore, see no shame in following their example.

AUDIT CLERKS.

It will not be amiss, before leaving this subject, to consider, very briefly, the desirable qualifications of an audit clerk. Conscientiousness may be placed in the foremost rank. A large amount of uninteresting detail must inevitably form a part of the clerk's daily routine; and the fact that the greater portion of such work may generally be "skimped," without any great danger of detection, affords considerable temptation, both to the naturally slow worker and to the gentleman of elastic conscience who wishes to make a little time for

himself. Reliability is the first requisite in a clerk, and the clerk who wishes to get on must endeavor to earn a reputation for being "safe." Next, the clerk would be wise—especially the young clerk—not to get too friendly with his client's staff. Let him be cautious of accepting favors, and *most* cautious of accepting presents—which might easily drift into bribes. In this respect clerks may sometimes find themselves in a very difficult position (more, perhaps, from force of circumstances than from weakness of character), and the possibility of such an occurrence adds another reason to those mentioned in the first chapter, to the desirability of occasionally changing the rounds of the audit clerks. Imagination (under proper control) is another very desirable quality in a clerk; for, without it, he is apt to become a mere machine and consequently next to absolutely useless to the auditor.

THE AUDITOR'S POSITION.

The position of the auditor varies to a certain extent with the nature of his appointment, and it will, therefore, be well to consider the circumstances separately.

THE AUDITOR TO AN INDIVIDUAL will, in almost every instance, receive his appointment from such individual in person; the appointment being—in the absence of stipulation to the contrary—for the period covered by the revenue account, but renewable upon the same terms for each successive period, unless a contrary agreement be made. The fee for the first audit is sometimes settled beforehand, but more usually left open until the time occupied has been ascertained, the fee for subsequent audits being usually arranged after the completion of the first audit. Naturally, the fee charged will be a matter of arrangement; but, in the event of no definite sum having been settled, the auditor would—in a case of disagreement—be entitled to such sum as a jury would award, which would probably be the usual professional charges. There would be no especial limit to the responsibilities of an auditor to a sole trader or manufacturer; if he

certify a set of accounts as correct, any third party (*e. g.*, a bank advancing money) relying upon his certificate would probably have exactly the same right to expect the accounts to be accurate as though the audit had been performed in pursuit of their own instructions. This is a point that should not be lost sight of, as one is very apt to reply upon the unsupported word of one's own client. At the same time, there is no reason why partial audits (the results of which are *not* certified) should not be made in the case of individuals or firms, provided there is a clear understanding between the client and the auditor as to the extent of the latter's examination. An auditor may resign his office at any time, but it is doubtful whether he could then claim to be paid for the time occupied upon an uncompleted audit. On the other hand, the client may at any time discharge his auditor, but he would probably be held liable for the whole fee of the current period, if the audit had been actually commenced.

THE AUDITOR TO A FIRM is usually appointed by the mutual agreement of the partners; but, occasionally, by the articles of partnership themselves, or by one particular partner. If appointed auditor *to the firm,* he must, however, in every case, consider each partner as his client, and protect the interests of each accordingly. The same conditions as to terms of agreement, responsibility, fees and resignation, obtain to the auditorship of firms as were mentioned in the previous paragraph; but it would seem that any one partner would have power to bind the firm as to the amount of the fees—except, perhaps, where the appointment lay in the hands of one partner, when the consent of such partner would probably be required. Probably no one partner could discharge an auditor without the consent of all his co-partners.

This seems the proper place to point out that in practice it not infrequently happens that the letter, if not the spirit, of partnership agreements is broken from time to time; and, so far as these infractions of the agreement relate to accounts, it is clearly the duty of the firm's auditor to draw attention

to the position of affairs in his report. The most usual irregularity of this description is for one or more of the partners to exceed the amount which they are entitled to draw on account of profits; and, although this overdrawing need not necessarily imply bad faith upon the part of the partner concerned, it is important for the auditor to draw attention thereto, if only for the sake of equitably adjusting the respective interests of the partners. Even where the partnership articles do not provide for interest upon either capital or drawings, it would be well to point out that, as a matter of equity, it is desirable that interest should be charged upon any excess of drawings over the authorized amount, inasmuch as these are clearly in the nature of a loan from the firm to the individual partner, and should, therefore—as a matter of right—carry interest in exactly the same way. In England the law provides that loans from the partners to the firm shall carry interest at the rate of five per cent. in the absence of express stipulation to the contrary. Any irregularities of this description should, therefore, be reported to all the partners; and, as a matter of convenience, it would appear to be desirable that such report should precede the actual closing of the accounts, so that the instructions of the firm may be taken upon the point and given effect to before the audit is completed. It is very desirable for the auditor to see that the accounts, after being finally agreed to, are signed by all the partners.

THE AUDITOR ON BEHALF OF CREDITORS.—It not infrequently occurs that a retiring partner, who leaves a portion of his capital in the firm, or a creditor who makes an advance to a firm, stipulates that "Mr. So-and-so shall audit the accounts." Unless the contrary intention be very clearly expressed, the auditor so appointed would act on behalf of both the firm and the creditor. In such a case it is very desirable that the amount of the fee be arranged beforehand, and it would not be wise to leave it an open question as to who was to pay it. Under the circumstances the firm could not, of course, remove the auditor without the consent of the credi-

tor; nor, in the absence of a special provision to that effect, could the creditor do so, and in any case he would probably be obliged to indemnify the firm against any extra expense occasioned by his so doing. The position of the auditor, in such a case as this, closely resembles that of the company auditor, except that the creditor would be entitled to the fullest possible information, while it is sometimes a question as to whether stockholders have an equally extensive right.

In the fourth English edition of this work attention was drawn to a serious abuse in connection with company prospectuses. These frequently put forward the name of a certain firm as the auditors of a company; but although the putting forward of a firm as auditors in this manner implies a certain measure of responsibility—moral if not legal—it conveyed to the firm in question no security that the directors of the company would subsequently confirm the appointment. This, however, has now been remedied by a provision in the English Companies Act, 1900, which requires every director to sign the prospectus before it is published. The directors thus become responsible for the accuracy of a statement that the firm named *are* the auditors of the company. In the United States it has not been customary to mention the names of proposed auditors, but certain recent events warrant the belief that this step will practically be forced upon company promoters hereafter, or the investing public will not be so keen to purchase the securities offered.

THE AUDITOR OF COMPANIES other than those under national or state regulation is subject to the rules and regulations of the company concerned, and to such further statutory provisions, if any, as may apply to the particular class of undertaking. The usual practice is for him to be appointed by the directors, although in many instances he is retained by the officers.

While it may seem rather far fetched to criticise an officer of a company for securing the services of a professional audi-

tor, particularly where, as is frequently the case, the stockholders and directors exhibit no interest whatever in the matter, yet an appointment under such circumstances is frequently responsible for placing the auditor so engaged in an unenviable position. It is not unnatural that a president, or a treasurer, who has, of his own volition, departed from the past policy of his company and called in a professional auditor, should feel some resentment if his own acts when under review do not meet with the approval of the auditor. This resentment is even more marked when the auditor has received the appointment largely as a matter of friendship (which is also of frequent occurrence), and the acts of his sponsor are made the subject of criticism. It is expected that the custom of an auditor being appointed by the stockholders, as provided by the English Companies Act, will shortly extend to the United States, and instead of the practice being followed by perhaps a dozen or two American companies, as is now the case, all or nearly all, of our corporations will shortly have a by-law containing this requirement.

It would seem that the shortest way to bring about such a desirable state of affairs would be by amending the general corporation acts of the several States, and it is hoped that such legislation will shortly be instituted.

In this connection it is of interest to note the following bill, which was introduced in the 1905 session of the Pennsylvania Legislature at the request of the President of the Pennsylvania C. P. A. Board:—

AN ACT.

Requiring the certification of a Certified Public Accountant of the State of Pennsylvania, as to the correctness of any financial statement issued by any corporation of this State or by any foreign corporation or corporation of other States, doing business in the State of Pennsylvania, for public information or for purposes of taxation, and to provide a punishment for the violation of this act.

Section 1. Be it enacted by the Senate and House of Representatives of the Commonwealth of Pennsylvania in General Assembly met and

it is hereby enacted by the authority of the same, that all corporations of the State of Pennsylvania or foreign corporations or corporations of other States, doing business in the State of Pennsylvania, upon issuing any financial statement inviting the purchase of their stock or bonds, or in issuing any monthly, quarterly, semi-annual or annual statements of the condition or business of such corporations, or any financial statements given to the newspapers, financial agencies, or other financial statements for the purpose of public information in the State of Pennsylvania or upon furnishing statements to the officials of the State of Pennsylvania, for the purpose of taxation, shall be required to have such statements verified by a Certified Public Accountant of the State of Pennsylvania.

Sec. 2. If any such corporation fails to have such certification made it shall be deemed and held guilty of a misdemeanor, and upon conviction thereof shall be fined not more than one thousand dollars, nor less than five hundred dollars, and any officer, agent or employee of such corporation furnishing a false statement, or any Certified Public Accountant certifying to the correctness of a statement issued by any corporation, when it is vitally incorrect or misleading, the officer, agent or employee making such false statement, and the Certified Public Accountant certifying to such false statement shall be deemed guilty of a misdemeanor, and on conviction thereof shall be sentenced to imprisonment for a term not exceeding two years and not less than one year, or a fine not exceeding five thousand dollars, nor less than three thousand dollars, or both.

It is, perhaps, needless to add that the bill did not pass. It was contended by some accountants that it was too drastic and that a statute requiring the certification of a Certified Public Accountant to the *annual statements* of corporations would be of more real value than any attempt to *compel* more frequent examinations.

Unless the remuneration of the auditor is fixed at the time of his appointment, he is entitled to reasonable remuneration; but if the by-laws provide that he shall be appointed at the annual meeting and receive "such remuneration as the stockholders may think fit," he is entitled to such sum as the general meeting may award him—and no more. Directors have no power to dismiss an auditor, if once appointed; but, apparently, an auditor may resign at any time, although probably

at the loss of his fees for the uncompleted work. If appointed by the stockholders a casual vacancy can be filled by an appointment at an extraordinary general meeting, but usually the directors would have power to fill a casual vacancy.

To a great extent it rests with the directors to decide how much information shall be supplied in the published accounts, but the auditor must not lose sight of his individual responsibility. He should be particularly careful to guard against juggling with words, and so appearing to give a full certificate, when in reality he is "making himself safe," or "hedging" behind a certificate which, when carefully analyzed (and only then), is found to be most qualified. He must, in every case, be satisfied in his own mind that the accounts are correct, and fairly stated.

RESIGNATION OF AUDITORS.—There is nothing whatever in connection with this subject in the English Companies Acts, 1862-1908, nor in any of our own corporation laws. Any right that the auditor may have to resign is, therefore, entirely founded upon custom. It is not for a moment disputed that an auditor would at any time have a right to resign his position, and were he to do so the "casual vacancy" which is referred to in the English Acts would, of course, arise; but it is surprising that the matter should not be dealt with more explicitly.

A point of considerable interest to all accountants is the question as to what an auditor ought to do when he finds himself in hopeless disagreement with the directors upon a question as to what ought to be done in the way of treating certain items in the company's accounts. Only too frequently the course adopted is for the auditor to resign, so that the directors can fill up the casual vacancy thus caused, by appointing some one who happens to agree with their own view, and so the whole matter is hushed up, and never comes to the knowledge of the stockholders at all. It is obvious that this procedure effectually detracts from the independence of an audit. If

there is any advantage at all in having an auditor, independent of the management, to supervise the accounts of a company, it is that in the event of his discovering anything which he thinks should come to the knowledge of the stockholders, then that something will be placed before them. Under the circumstances existing prior to the passage of the Companies Act of 1908, it was probably not once in ten times that an occurrence of this kind was ever found out by the stockholders. All that they knew was that the accounts had been audited. They had probably quite forgotten the name of the previous auditor, and no intimation was made to them of the fact that a change had occurred.

The Companies Act of 1908, however, has remedied this condition to a very considerable extent as far as our English brethren are concerned. This act provides, *inter alia,* that only the retiring auditor shall be eligible for appointment for the coming year, unless notice of intention to make another nomination has been given previous to the annual meeting, a copy of such notice having been sent to the retiring auditor, and all the stockholders likewise notified, prior to the date of the meeting. This course of procedure protects the auditor as the proposal to change auditors would naturally cause inquiry to be made as to the reason therefor, thus giving the auditor an opportunity to acquaint the stockholders with the facts.

Until it becomes the custom in the United States for stockholders to appoint the auditor of a corporation, the auditor will always be at more or less of a disadvantage as the directors—in the case of a disagreement between themselves and the auditor or in the event of the auditor criticising any of their actions—can simply publish the accounts without the auditor's certificate and the average stockholder be none the wiser.

"PRIVILEGE" OF AUDITORS.—Another reform in this connection which is earnestly needed is absolute "privilege" upon the part of an auditor in his reports. To a certain

extent he, no doubt, has this privilege at the present time; but the point is not free from doubt, and it should be absolutely clear. If the auditor is of the opinion that something which has been done by the directors, or by any outside persons, calls for the attention of the stockholders, he should be in such a position that he need feel no hesitation in expressing his view. He ought also to have a clearly defined right to circularize the stockholders, if need be, at any time; and more particularly, in the event of his having resigned, as to the reasons for his resignation. It will, of course, be said that, were this done, many sound companies and many honest boards of directors would be placed at the mercy of unscrupulous auditors; but there is at least no more harm in a company being at the mercy of unscrupulous auditors than its being at the mercy of unscrupulous directors, and unquestionably the latter are more common than the former. Besides, the auditor would always be liable to be called upon to justify the position which he had taken up; and nothing could protect him in the way of "privilege" if it could be shown that he had not been actuated by motives of good faith.

REMOVAL OF AUDITORS.—Passing on to the question of the removal of an auditor. Under the English Companies Act, this can only be done by the company at its annual general meeting—that is to say, the only practical way of removing an auditor is not to re-elect him when his year of office has expired. As, however, most companies only require the services of their auditors immediately *before* such annual meeting, this for all practical purposes amounts to an appointment at will; and, in view of the fact that, under any but the most abnormal circumstances, the directors of a company can always secure a majority at a poll, it will be seen that the auditor practically holds his appointment from the directors, even although he may nominally receive his appointment from the stockholders. That section of the Companies Act of 1908 to which reference has been made under "Resignation of

Auditors" secures to a certain extent the auditor's tenure of office.

Of course, under the present practice in the United States (where an auditor is appointed by the directors, or the officers, for a specific purpose) the question of his removal rarely arises.

DUTIES OF AUDITORS.—With regard to the question of the duties of an auditor while in office. There being, up to the present at all events, no very definite provisions with regard to this matter, the question is largely one of contract between each individual auditor and the company. The basis of that contract will be construed by the courts chiefly from the facts of each individual case.

In this connection it may be pointed out in passing that, even with regard to such important questions as the value of assets, provision for depreciation, the assessment of profits earned, and the distribution of unrealized profits, the courts have shown a marvelous disinclination to lay down any general rules which could be regarded as principles for the safe guidance of auditors in the future. In carefully and laboriously shirking their duties in this respect, however, the courts have been most ably seconded by the legislatures, which have been particularly cautious in abstaining from laying down any exact rules as to what the duties of an auditor may be. No doubt they have acted wisely in adopting this course, however, because any attempt to state explicitly what the duties of auditors are in all cases would inevitably fail in not a few, and would afford the best possible excuse for the insufficiency of the audit that had been performed in such cases. Any legislative act which attempts to classify the duties of an auditor under stereotyped headings must at least profess to be at the same time exhaustive, and as the latter is impossible, it seems to follow that the former is very inexpedient.

RIGHTS OF AUDITORS.—The rights of a company auditor may be very shortly dismissed. He has but few. He

has the right, when appointed by the stockholders, to hold office till the next annual meeting of the company, and in the absence of notice prior thereto of other nominations for the office, the sole right to appointment for the coming year. He has also the right to reasonable remuneration, or at such a rate as the company is general meeting may be pleased to allow, where he is acting under a specific provision to that effect. When appointed by the stockholders, he has the right to examine the books and accounts of the company at all reasonable times (which, unless coupled with a reasonable scale of remuneration, is, perhaps, rather more of a curse than a blessing).

When appointed by the directors, he usually has the right to make inquiries from any of the officers of the company.

When appointed by the president of a company, who is, perhaps, the officer usually charged with selecting the auditor, he usually has the right to make inquiries from any of the *other* officers, and sometimes he may interrogate the president himself!

When appointed by the treasurer, who is also frequently authorized to employ the auditor of his own accounts, he must simply discharge his duties and accept his full measure of responsibility, even though he cannot help seeing that a certain kind of report is equivalent to notice that his services will not be required at the next audit.

In this connection it may be interesting to note some of the provisions with respect to auditors which are contained in the English Companies (Consolidation) Act, 1908 (8 Edw. 7, Ch. 69).

Section 112.—(1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting.

(2) If an appointment of auditors is not made at an annual general meeting, the Board of Trade may, on the application of any member of the company, appoint an auditor of the company for the current

year, and fix the remuneration to be paid to him by the company for his services.

(3) A director or officer of the company shall not be capable of being appointed auditor of the company.

(4) A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the annual general meeting, and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to the shareholders, either by advertisement or in any other mode allowed by the articles, not less than seven days before the annual general meeting:

Provided, that if, after notice of the intention to nominate an auditor has been so given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this provision, be sent or given at the same time as the notice of the annual general meeting.

(5) The first auditors of the company may be appointed by the directors before the statutory meeting, and, if so appointed, shall hold office until the first annual general meeting, unless previously removed by a resolution of the shareholders in general meeting, in which case the shareholders at that meeting may appoint auditors.

(6) The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act.

(7) The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of any auditors appointed before the statutory meeting, or to fill any casual vacancy, may be fixed by the directors.

Section 113.—(1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors.

(2) The auditors shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before

the company in general meeting during their tenure of office, and the report shall state—

(*a*) whether or not they have obtained all the information and explanations they have required; and

(*b*) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

(3) The balance sheet shall be signed on behalf of the board by two of the directors of the company, or, if there is only one director, by that director, and the auditors' report shall be attached to the balance sheet, or there shall be inserted at the foot of the balance sheet a reference to the report, and the report shall be read before the company in general meeting, and shall be open to inspection by any shareholder.

Any shareholder shall be entitled to be furnished with a copy of the balance sheet and auditors' report at a charge not exceeding sixpence for every hundred words.

(4) If any copy of a balance sheet which has not been signed as required by this section is issued, circulated, or published, or if any copy of a balance sheet is issued, circulated, or published without either having a copy of the auditors' report attached thereto or containing such reference to that report as is required by this section, the company, and every director, manager, secretary, or other officer of the company who is knowingly a party to the default, shall, on conviction, be liable to a fine not exceeding fifty pounds.

(5) In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine—

(*a*) if the company has branch banks beyond the limits of Europe, it shall be sufficient if the auditor is allowed access to such copies of and extracts from the books and accounts of any such branch as have been transmitted to the head office of the company in the United Kingdom; and

(*b*) the balance sheet must be signed by the secretary or manager (if any), and where there are more than three directors of the company by at least three of those directors, and where there are not more than three directors by all the directors.

Section 114.—(1) Holders of preference shares and debentures of a company shall have the same right to receive and inspect the balance

sheets of the company and the reports of the auditors and other reports as is possessed by the holders of ordinary shares in the company.

(2) This section shall not apply to a private company, nor to a company registered before the first day of July, nineteen hundred and eight.

CHAPTER X.

THE LIABILITIES OF AUDITORS.

THE LIABILITIES OF AUDITORS.

Turning now, again, to the general aspect of the question, it will be well to consider the extent of the auditor's liability in connection with accounts that he has certified.

The question appears to be capable of division under two heads, viz.:—

(1) What is the actual extent of the auditor's certification?

(2) What is his legal responsibility in case of an error being subsequently discovered in accounts that have been passed by him?

To take these two points separately:

THE EXTENT OF AN AUDITOR'S CERTIFICATION.

Unfortunately, this is a matter upon which the profession is by no means agreed; while, on the other hand, the cases that have been decided by the courts are so few, and the questions actually at issue so narrow, that sufficient precedents are not even yet available to definitely settle the matter. At the same time, it is well to remember that, however desirable it may be to know exactly the bare extent of the legal responsibility, the real professional responsibility to clients ought always to be the ideal; and, further, an auditor will be the worst of friends to his profession if he studiously exert himself to narrow the responsibilities, and so to dwarf the importance of his position.

The responsibility involved in certifying a balance sheet to be absolutely correct would be so great, so limitless, that many have preferred to discard all claim to such a position of certainty, and prefer merely to certify a balance sheet as being "in accordance with the books." Auditors, however, will hardly require to be reminded that an investigation which had been limited to the comparison of a balance sheet with the books would be, for every purpose, absolutely valueless. So obvious is this conclusion that no professional auditor would ever think of confining his investigation to this particular point, yet many experienced auditors appear to be afraid to make any certification as to the result of such further investigation as they know to be essential. Such a state of affairs is unsatisfactory to the client and discreditable to the auditor. Again, it is a very open question whether so unsatisfactory a certificate would ever have the effect of limiting the legal responsibility of the auditor to the exact points certified. It is, at least, possible that our courts would view the matter from a broader aspect, and consider that the man who had accepted the position of auditor to say nothing of the fees incident thereto—had also undertaken the responsibilities of that position—and that it would be disposed to form its own opinion as to the real extent of such responsibilities. Such, indeed, appears to have been the view taken in an English case by Justice Stirling, in the case of *The Leeds Estate, &c., Society*. (Pages 310, 358 hereof.) It would appear, therefore, that the auditor who does not consider his investigation has been sufficiently searching escapes no liability by issuing a carefully modified certificate; and, indeed, such a course is somewhat dishonest. These are strong words, but not stronger than the circumstances appear to require.

But it is not intended to convey the impression that an auditor who through no fault of his own, has been unable to make a satisfactory investigation, and who makes no attempt to conceal the actual facts in his certificate, is censurable. He, of course, has not issued a "carefully modified" certificate.

The English Companies Act of 1908 requires the auditors to make their qualifications, not at the foot of the published accounts, but in a report which the directors are required to have read at the general meeting. This report may—and, of course, should be—as lengthy and as detailed as circumstances may require, and there is thus—now, at least—no excuse for cryptic certificates which may mean anything or nothing. While there is no statutory requirement in effect in the United States governing the form of auditor's reports, it is suggested that the auditor should so word them as to encourage by every means that lies in his power, an intelligent and active interest on the part of stockholders in the accounts of the company, and in its finances generally.

A very careful search of the Supreme Court Reports of each State in the Union fails to reveal a single case bearing on the liabilities of professional auditors. We must, therefore, resort to the English decisions, which are fairly numerous.

It may be added that the English standard is by no means too high, and may be accepted as a proper criterion for American practitioners. Furthermore, it is altogether likely that until a line of American decisions has been established the identical cases here reported will be used as precedents for the American cases which may arise.

Many years ago a prominent English accountant expressed himself as follows: "I know perfectly well that a proper auditor must go further (than comparing the published accounts with the books) and see that the books themselves do correspond with facts," and this view appears to be endorsed by the legal decisions to be considered later on. As to how far it is possible for this standard to be carried into practice, there is, perhaps, room for some difference of individual opinion, but the general statement is absolutely unassailable.

In actual practice, however, the question naturally arises: How is the auditor to ascertain the actual facts? To which

it may be replied: In the same manner as a judge or jury—*by sifting evidence.* The chief evidence is, of course, the books (and it may be remarked incidentally, that it is clearly the auditor's duty to see that the accounts he certifies, in addition to being correct, *are* in accordance with the books), but the books must not be considered the sole source of evidence; the fact that a statement appears in the books is *prima facie* evidence only, and must be verified, either by internal cross examination, or by reliable and independent evidence, whether documentary (vouchers, &c.) or oral (explanations).

The result of such an investigation will be that the auditor has proved to himself that certain statements represent absolutely indisputable facts, and that certain other statements, *in his opinion,* appear to represent facts. Beyond this—not being omniscient—he cannot go, and should never attempt to go. Let him, therefore, report that he has thoroughly examined the accounts, that they are in accordance with the books, and are, in his opinion, correctly stated; he will then be occupying a logical, manly position—far more in keeping with the dignity of his profession than that afforded by the most skilful of word-juggling.

The view laid down in the two preceding paragraphs is that which appeared in the first English edition of this work, which was published in 1892, before the *London and General Bank* had failed, and before the celebrated case in connection with that failure was thought of; but nothing that has since occurred has in any degree tended to discredit the line of argument then taken. On the contrary, the judgment of Lord (then Lord Justice) Lindley fully endorses the author's view. This judgment, together with that of the late Lord Justice Rigby, will be found fully reported in Appendix "A"; but for the sake of clearness, and on account of its extreme importance, it has been thought desirable to reproduce here the following extract from Lord Justice Lindley's judgment:—

"It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has noth-

ing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the auditor has to frame* a balance sheet, showing that position according to the books, and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Mr. Justice Stirling in *The Leeds Estate Company v. Shephard,* in 36 Chancery Division, page 802. An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; *he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.*

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also.

* This is clearly a *lapsus linguæ:* it is no part of an Auditor's duty to prepare accounts, but to examine and report upon accounts prepared by, or on behalf of, the directors.

Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert, where special knowledge is required.

"Mr. Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance sheet. He did not content himself with making his balance sheet from the books without troubling himself about the truth of what they showed. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were correct, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty. It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognized as correct by business men."

The reasons why their Lordships felt constrained to give judgment against the defendant, notwithstanding the fact that they could "see no trace whatever of any failure by him in the performance of this part of his duty," will be considered under the following sub-heading.

Since the second English edition of this work was published several important decisions with regard to the liability of auditors have been delivered by the English Courts, which—to a certain extent, although still very unsatisfactory—tend to further define the extent of an auditors' certification. It is thought that the points raised in these various judgments can be more conveniently dealt with under the heading of the liabilities of auditors. It may be mentioned here, however, that, in the *Kingston Cotton Mills* case, it was decided by Mr. (now Lord) Justice Vaughan Williams that although the directors of a company were justified in accepting the certificate of the managing director as to the amount of stock in hand, the auditors were—at all events in that particular case—not so justified, and that although their certificate was qualified accordingly; but this decision was overruled by the Court of Appeal.

An interesting side-light upon the exact extent of an auditor's certification is afforded by the proceedings of the Select Committee of the House of Lords appointed in 1896 to inquire into Company Law Amendment, upon the occasion of the examination of Mr. Frederick Whinney, F.C.A. The following extract from the published report of these proceedings will be found of no little interest, but it is important to remember that, although some of the Law Lords have here expressed themselves in terms that appear to be widely different from those which have from time to time been used by other judges, they were not speaking *ex cathedra;* and further that, although the distinct suggestion is that, should a case be brought before it, the House of Lords might see fit to overrule some of the decisions already given by the Court of Appeal, it does not necessarily follow that their Lordships would adhere to those views (as expressed below) when the time came:—

"Passing to clause 29, which deals with the appointment of auditors, he suggested the addition of words to the effect that, unless it was otherwise provided by the articles of association, one of the auditors or the auditor, if there was only one, should be a professional accountant, and should not necessarily be a shareholder. In support of that proposition, he pointed out that joint-stock enterprise had grown very largely of late years, and he maintained that very few balance sheets could be audited properly except by a professional accountant. He went on to suggest the insertion in the bill of a provision that no auditor, other than the retiring auditor, should be appointed at a general meeting, unless notice had been sent out to the shareholders with the notice of meeting. That, he said, was brought forward with the object of preventing the question of the auditor being 'rushed,' as was sometimes the case at present. The bill provided that there should be a balance sheet containing all details—technically, what was known as the trial balance. It was scarcely necessary to provide for that by legislation, because a balance sheet could not be made out unless the details were given. As to the duties of auditors, the bill proposed that they should use reasonable diligence with the view of ascertaining that the books of the company had been properly kept, and recorded correctly the financial and trading transactions of the company. The latter part of the section he did not object to, but he thought the words 'properly kept' should be omitted. 'Properly kept' was a vague term,

and the section would be quite sufficient to meet the difficulty without its insertion. It would be the duty of the auditors to say that the books had not been properly kept if that was the case.

"The bill cast upon auditors the duty of checking the balance sheet, including the amount of debts due to the company after making a proper deduction for debts considered to be bad or doubtful. It would be impossible for the auditors to do that in the case of large companies, where the debtors numbered, say, 1,000. In the case of banks, for instance, where the number of debtors was very large, it was found necessary to keep an aggregate account of debtors, showing the total amount due to the company by its debtors. The auditors would have to take that account, and schedules would be prepared, and, if necessary, would be tested afterwards. The duty should not be thrown upon auditors of checking every balance. In one case he might mention the debtors numbered 750,000. (Laughter.) It should be sufficient if they gave a certificate to the effect that they had used all reasonable care and diligence in ascertaining that the balance sheet was true."

Lord Davey: "I should like to ask whether you conceive it to be the proper duty of an auditor to say not only whether the books are properly kept, but to go into questions behind the books, and say whether the assets are properly valued?"—"I do not know that I can give a better definition of the duties of the auditor than that laid down by Lord Justice Lindley. He said that it was the duty of an auditor to be honest, to exercise all reasonable care and skill to ascertain that that which he certifies is true, and to exercise all reasonable care and skill in ascertaining the truth."

Lord Farrer: "That is all very well; but what is the truth which he is to ascertain?" Lord Davey: "Yes; that is it. Can he, for intance, when the properties are valued at a certain sum in the books, and on the face of the books are properly valued, can it be his duty, not being a valuer, to go into the question of value and say that the directors have put too high a value on the real estate?"—"No; I do not think so. It would be giving the auditor a different position from that which it was contemplated he should have—namely, that he should examine the accounts of the directors and see whether they are correct. Anything calculated to arouse his suspicion he ought, of course, to look into."

Lord Farrer: "After all, the responsibility lies with the directors?" —"Not altogether with the directors. There are the managers of the company."

LORD FARRER: "Do you wish to place the auditor in the position of an administrator, who is to check the directors in their management of the company?"—"Certainly not."

LORD DAVEY: "Is not the sounder principle this—that the auditor is bound to know everything the books tell him, to have all the suspicions that the books suggest, and to make all the inferences to what he finds in the books would lead him?"—"I think that would cover the whole of his duty. I think it is his duty not to certify a balance sheet until he believes it to be true, and he has taken all reasonable care that it is so. He is bound to see that the balance sheet is brought before the shareholders in such a form that they themselves can exercise their judgment upon it."

"The next suggestion he had to make was that the pains and penalties of auditors should be modified. At present the auditor was supposed to be responsible if dividends were paid out of capital."—LORD DAVEY: "Is he? I never knew it"— The LORD CHANCELLOR: "Putting aside fraudulent connivance, what do you suppose to be the responsibility of an auditor?"—The witness: "That if dividends have been paid out of capital, assuming, of course, that the company is wound up, the directors and auditors are responsible for the amount of the dividends so paid, subject to the Statute of Limitations in favor of the auditors."—LORD DAVEY: "Where do you find that?"—The LORD CHANCELLOR: "I am not aware of any such law. I am not aware of any case in which the innocent mistake of a director has been held to be the subject for an action."—The witness: "There was a case before Mr. Justice Stirling."—LORD DAVEY: "There, there was fraudulent connivance."—The witness: "I think there was not connivance, but that the auditor himself was ignorant."—The LORD CHANCELLOR: "To me it is a startling suggestion that for an innocent mistake an auditor should be liable."

The view expressed by Lord Davey above was, it will be seen, that the auditor is bound to know everything the books tell him, to have all the suspicions the books suggest, and to make all the inferences to which all that he finds in the books would lead him. This, taken by itself, is a somewhat narrower view than had been previously suggested in the course of this chapter—namely, that the books must not be considered as the sole source of evidence—but it is thought there is very much less difference between these views than is at first apparent, and that Lord Davey's view that the auditor should "have

all the suspicions which a careful examination of the books would give him" amounts to very much the same thing as the opinion, already expressed in these pages, that the books themselves are *prima facie* evidence only, and must, in all cases of doubt, be verified by independent inquiry.

AUDITOR'S LIABILITY FOR DEFALCATIONS OF EMPLOYEES.

The question as to whether—and if so, to what extent—an auditor is liable to his clients for defalcations committed by their employees, is one of very considerable importance, but, unfortunately, the English precedents upon the subject are not sufficient to satisfactorily establish any general rule, and so far not a single American precedent can be found. The reports in *Wilde v. Cape & Dalgleish* and *Martin v. Isitt* (both of which will be found in Appendix "A") may advantageously be consulted in this connection; but it cannot be pretended that there is any degree of finality about them. Pending further decisions, however, it may, perhaps, not unreasonably be assumed that, in this (as in other) respects, the auditor will be liable, in most of our States at least, to be proceeded against by way of action for negligence in the discharge of his duties; and, if it could be shown that the defalcations had resulted from the negligence or incapacity of the auditor, the probability is that he would be held liable in damages accordingly. The most interesting of the two cases in question is undoubtedly that of *Martin v. Isitt,* in which the plaintiffs claimed damages by reason of the fact that the monthly audit, which the defendants had contracted to perform, had been allowed to fall into arrear, and that the defalcations had remained undetected for a longer period than, in their view, was reasonable. The case was eventually settled without any definite expression of opinion upon the part of the judge as to its merits; but doubtless, in so far as the delay in the monthly audit was unreasonable, the auditor would be responsible for any loss incurred by his clients in conse-

quence. The question is obviously, therefore, one of the very greatest importance to American practitioners, as showing the extreme desirability of monthly and other periodical audits being punctually proceeded with, and the case cited might profitably be re-read at intervals, particularly by auditors who make a specialty of periodical audits. On the other hand, a reasonable margin would, no doubt, in all cases be allowed. It would be manifestly impossible for an auditor to commence his investigations in all cases *immediately* after the period had elapsed, and consequently it is only reasonable to suppose that some elasticity would be used in applying the general rule; otherwise the position of professional auditors, say, in the month of January, would be a serious one.

With regard to the later decision upon the liability of auditors in the event of defalcations on the part of employees given by the Irish Court of Appeal in the case of the *Irish Woollen Co., Lim.* (a report of which appears in Appendix A), it is important to bear in mind that the decisions of this court are not legal precedents in England, and would have little weight with our own courts; but, be that as it may, it is thought that the proposition previously advanced can now be entertained with even less doubt than before—namely, that where loss is incurred through the defalcations of employees, which defalcations might have been discovered or prevented by the exercise of due diligence the auditor will be liable. It may also be mentioned that in this case stress was laid on the agreement between the auditor and the company that there should be a "monthly" audit, although there appears to have been some conflict as to what was actually intended by this arrangement. The circumstances were as follows:

Dividends had been paid out of capital on the faith of accounts which were afterwards discovered to have been falsified, and the charge against the auditor may (in effect) be divided into three headings:—

(1) That he failed to discover that the stock had been over-valued.

(2) That he failed to discover that the book debts had been overvalued

(3) That he failed to discover that the trade liabilities had been understated.

With regard to (1), the case would appear to be upon all-fours with the decision in the *Kingston Cotton Mills* case, and for much the same reasons the decision of the court was in favor of the auditor.

(2) Here, again, the court decided in the auditor's favor, on the ground apparently that he could not be held responsible for the insufficiency of the reserve provided against bad debts, nor for the omission to provide for cash discounts. With regard to bad debts, it is quite clear that all an auditor can do is to make reasonable inquiries as to the sufficiency of the provision made, and the final responsibility must in all fairness rest with the directors and managers; but it would appear to be the duty of an auditor to form a reasonable opinion as to the sufficiency of the reserve, and to qualify his report if in his opinion such reserve is inadequate. Upon the subject of cash discounts it would not have been surprising if the court had held that a proper provision *ought* to have been made for the amount which it was expected would eventually be deducted on payment of the various accounts, although, of course, *per contra* cash discounts might properly be deducted from the trade liabilities. In this respect the decision of the Court of Appeal is, perhaps, more favorable to the auditor than might have been expected.

(3) It was in respect of his failure to discover that the trade liabilities were understated that the auditor was held liable for negligence. There would seem to have been a systematic falsification of the books in this respect, and had this falsification been discovered at an earlier stage, it would have been clear that the dividends paid had not been earned. Incidentally, the discovery of falsification in the books under this heading would naturally have aroused suspicion as to the

accuracy of the records under headings (1) and (2). Without having the actual books before one it is difficult—if not impossible to express any opinion as to whether or not a reasonably careful and skilful auditor could have discovered the frauds; but the report of the case distinctly suggests that there were points which would call for careful inquiry, and upon which in point of fact inquiry was actually made by the auditor. He would appear to have noticed that certain invoices were not entered in the books until after the period to which *prima facie* they related, and to have inquired as to why this course was pursued. The explanation given, apparently, was that the goods relating to these invoices had not been included in stock. The explanation is by no means unreasonable, as such a practice is certainly not contrary to the custom of many perfectly honest undertakings. In the *Kingson Cotton Mills* case it was stated that "auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud when there is nothing to arouse their suspicion, and when these frauds are perpetrated by tried servants of the company, and are undetected for years by the directors." It may be thought that these remarks would apply equally well to the *Irish Woollen Company* case; but it may be pointed out that the practice of "holding back" invoices because goods have not been taken into stock, although perhaps in itself permissible, is one which—considerations of fraud apart—might easily lead to mistakes. So that, if any means *are* available for checking the records of the transactions, such means ought not to be neglected by a reasonably careful auditor. It appears that the suppression of invoices would have been at once discovered, had the auditor taken the precaution of comparing the purchase ledger balances with the statements of account forwarded by the various creditors; and, that being so, it seems reasonable to have held that he was guilty of negligence in omitting to take this precaution. Taken by itself, however, this would hardly afford grounds for a suit for damages. It is true that the "stock-taking"

statements would only have disclosed "suppressed" invoices, and would not have thrown any light upon the invoices "carried over"; but the discovery of a large number of invoices altogether suppressed would at once arouse suspicion in the mind of any careful auditor, and throw upon him the onus of further and more exhaustive inquiry. In the "soft goods" trade it is customary in England for creditors to be asked to send in "stock-taking" statements to be compared with the purchase ledger balances, so that particularly in the case of a concern carrying on such a business as that of the *Irish Woollen Company, Lim.*, does it seem reasonable that the auditor should have been expected to take this precaution?

The most recent decision in conection with the liability of an auditor for failure to detect defalcations is that in the case of the *London Oil Storage Company, Lim., v. Seear, Hasluck & Co.* (*vide* Appendix "A"), which came before the Lord Chief Justice and a special jury in June, 1904. To the casual onlooker this case would appear to be quite straightforward, but Lord Alverstone devoted so much care to his summing up that it seems clear the matter struck him as being one of more importance and more difficulty than to the ordinary observer to be the case. The principles governing the matter were, he said, clear, but the practical application of those principles to any individual case a matter of the very greatest difficulty. This admission is to be welcomed, as affording a most acceptable contrast to the manner in which the courts regarded the views of auditors a dozen years ago; but if the situation in the case referred to is so difficult as to seriously tax the intelligence of a special jury, it is clear that the author was by no means overstating the case when—in the fourth English edition of this work—he expressed the view that such important and such highly technical matters ought not, in fairness to auditors, ever to be decided by a single judge. Briefly stated, the points at issue here were as follows: During a number of years the defendants had never taken any steps to verify the amount of cash in hand appearing on the

balance sheet. During those years the amount of this balance had very materially increased, and during the latter part of the period had not been shown separately from the balance at bank. Eventually, owing to the illness of the responsible cashier, it was discovered that the bulk of this balance was non-existent, with the result that the company sustained a loss of some hundreds of pounds. On behalf of the defence it was argued (1) that in the absence of suspicious circumstances an auditor was entitled to rely upon the statements of trusted employees (*vide Kingston Cotton Mills* case); (2) that there were no suspicious circumstances here; (3) that the directors had not had their suspicions aroused, and, therefore, if the case was one for suspicion, they were at least equally negligent; (4) that there was no evidence to show that the whole of the deficiency in the cash balance did not occur since the date of the last audit, in which case clearly the auditor could not be responsible. The jury found that during the last four years the auditor had committed a breach of his duty, and they assessed the damage sustained owing to this breach of duty at five guineas, adding as a rider that they considered the directors had been guilty of gross negligence. Upon the whole, this verdict seems to be a very fair one, and certainly it cannot be said to err upon the side of severity. It is thought, however, that the defendants made their case worse by adopting too low a view of auditorial responsibility. There are, of course, many things that an auditor *must* from time to time take upon trust; but under normal circumstances the balance of cash in hand seems to be the one asset in a balance sheet that is really capable of absolute and unconditional verification. In the absence, therefore, of very exceptional circumstances—as, for example, in the case of an undertaking having numerous branches—the cash in hand should invariably be verified by the auditor. The actual enumeration of the balance of cash in hand at each branch may not be practicable, but so far as can be gathered no such difficulty arose here; while again the very considerable increase of cash in hand (an increase in no way connected with the actual requirements of the

business) ought, it is thought, to be in all cases regarded by the careful auditor as a matter calling for careful inquiry, if not actually a matter for suspicion. That the directors showed gross negligence in allowing such a large balance to accumulate in the hands of one of the employees of the company goes, of course, without saying; but it would be straining the decision of the Court of Appeal in the *Kingston Cotton Mills* case too far to suggest that, however negligent the directors of a company may be, so long as *they* are satisfied the auditor need inquire no further. Did that really represent the true limit of an auditor's duties, those duties might be regarded as adequately discharged if the auditor did nothing more than require the directors to sign the draft balance sheet before he did so himself! It is obviously in the interests of professional auditors that their duties should not be made unduly onerous, and that they should not be held responsible for the absolute accuracy of statements contained in the accounts which in the nature of things it is impossible for them to completely verify; but it is thought that it is equally in the interests of the profession that, within such limits as may be practicable, the full responsibility of auditors for the performance of their duties with reasonable care and reasonable skill should be rigidly enforced.

LIABILITY OF AUDITORS FOR LIBEL.

The question of the liability of an auditor for libel or slander is one which so far as is known has never yet been seriously raised in America or elsewhere, but it would seem that the ordinary rules of law would apply hereto. That is to say, that, when the alleged libel or slander is true in point of fact, and is published by the auditor in good faith and without malice, and in the *bona fide* discharge of his duty, it would, no doubt, be held to be privileged. So far, the proposition is eminently satisfactory; but there still remains for consideration the position of the auditor, assuming that he were mistaken in his facts, or assuming that he had—in all good faith—gone some-

what outside the actual scope of his duty in the particular matter. In these cases it is thought that the question would be primarily one for a jury to decide, but that every reasonable indulgence would be allowed to the auditor who had acted in good faith and without malice. Against this, however, it may be mentioned that in the unreported action of *Weiner v. Wurtemburg Electro Plate Company and another,* which was decided in England in 1895, the plaintiff claimed damages against the defendants for libel, on the ground that the defendant company had instructed and authorized the co-defendants (a firm of Chartered Accountants) to issue a circular to their customers, stating, *inter alia,* that the plaintiff was no longer in their employ, and that "the bookkeeper had already been arrested on a charge of felony." Mr. Justice Hawkins (now Lord Brampton, P. C.) summed up very strongly in favor of the defendants, but the jury found a verdict for the plaintiff with £50 damages. The question as to whether or not an auditor would be held liable in any particular case is thus really more dependent upon the vagaries of the jury concerned than upon any settled question of law, and the position is, therefore, a highly unsatisfactory one.

It may be added in this connection that in England it is settled law that, when it is part of the duty of any persons to attend a meeting and to address it, any statements there made by them in good faith are privileged. Whatever an auditor may state in his report to the stockholders, under Section 19 of the English Companies Act, 1908, is therefore clearly privileged. As to how far this would apply to verbal statements made by an auditor at the general meeting of a company may, however, be reasonably doubted, inasmuch as it is by no means clear that an auditor has any statutory right under their Companies Act to attend general meetings. Indeed, it has been held by a county court judge that he has no such right; and, although this is a view from which probably some may differ, the point is by no means altogether free from doubt. It has certainly never been settled in the affirmative.

American laws relating to libel and slander vary with the different States, and can hardly be said to be in harmony; it is, therefore, not feasible to discuss them within the limits of this volume. It is suggested, however, that it would be only prudent for professional auditors to acquaint themselves with the statutes of their own States bearing on these subjects.

THE RESPONSIBILITY OF THE AUDITOR FOR ERRORS.

Having now discussed the practical extent of the auditor's certification, it is time to pass on to a consideration of his liabilities, in the event of his investigation having failed to detect and expose errors or frauds.

CRIMINAL LIABILITY OF AUDITORS.

This is a question which need not long detain us, inasmuch as the reported cases are few and far between. In the *Portsea Island Building Society* case, criminal proceedings were instituted against the directors and the secretary of the society, but not against the auditors. The directors were, however, acquitted, and the case is only of interest in this connection, inasmuch as Mr. Justice Hawkins very clearly stated, in the course of his summing up, that the evidence before him had established a *civil* liability upon the part of the auditor.

In the case of the *Lancaster Building Society,* the auditor, among others, was charged with various criminal offences, but was acquitted; and the judge in his summing-up stated to the jury that, no matter how scandalous the negligence of an auditor might be, they would not be justified in returning a verdict of guilty unless they were satisfied that there was evidence of "not only criminal negligence, but also of fraudulent intent."*

* This, of course, was before the English Companies Act 1900 was passed.

The auditors of the two Newfoundland Banks which failed in 1894 were also tried, in conjunction with the directors of their respective companies, and likewise acquitted.

Since the fourth English edition of this work was published, an important decision has been given that supplements, although it does not modify, the views already expressed. At the trial of the auditors and certain other officials of *Dumbell's Banking Company, Lim.*, which was held at Douglas, Isle of Man, in November, 1900—the prosecution took place under the Manx Criminal Code of 1872, but the wording of this section is identical with that of the English Act of 1862 (24 & 25 Vict., c. 96, section 84), so that the precise locality of the prosecution introduced no distinctive element—the defendants were convicted of having joined in the issue of false balance sheets, knowing them to be false, and with the intention to deceive, and were accordingly sentenced to varying terms of imprisonment.

If it were necessary to deal at length with the merits of this particular case, much space might be devoted to a discussion of the evidence, with a view to seeing whether the charges put forward were actually proved up to the hilt in all cases; but for the purposes of a general work of reference this is not required. It may be pointed out, however, that under Section 28 of the English Companies Act 1900 any person who "wilfully makes a statement false in any material particular" in "any return, report, certificate, balance sheet, or other document, required by or for the purposes of "that Act, "knowing it to be false," is guilty of a misdemeanor, and liable on conviction to fine or imprisonment. This section goes somewhat further than the Act of 1862, inasmuch as it is no longer necessary to prove *intent* to deceive or defraud; but it is thought that the distinction is more apparent than real, seeing that anyone who wilfully makes a false statement, "knowing it to be false," would invariably be assumed by an average jury to have made it for some purpose, and it is unlikely in the extreme that the purpose would be an in-

nocent one. Practically, therefore, the law probably stands exactly where it did before the passing of the 1900 Act, save that possibly the trial of any person charged thereunder might now be somewhat shortened.

Another recent criminal case which is of interest in this connection, although the auditors were in no way involved, is the trial of the Managing Director and Breweries Manager of *Showell's Brewery, Lim.,* in March, 1904, on various charges of fraud. The defendants, who were convicted and sentenced respectively to fifteen months' and nine months' imprisonment, had for many years systematically overvalued the stock-in-trade, and had induced subordinate employees of the company to certify to these valuations on the representation that they were more than covered by existing secret reserves. The case is, it is thought, chiefly of interest to auditors, in that it draws attention to a possible very serious abuse of secret reserves, and emphasizes the importance of an auditor very carefully inquiring into the circumstances under which recourse is had to such reserves during "lean" years to conceal the comparatively poor results then achieved. It has been stated in some quarters that if the False Statements (Companies) Bill, 1904, were passed, it would be impossible, in England, for directors to ever maintain a secret reserve without committing a criminal offence. This, it is thought, is an exaggeration. It is, however, important that both directors and auditors should bear in mind that the mere fact that secret reserves exist proves that, to some extent at least, the directors are not entirely candid with their stockholders; and the absence of absolute candor naturally necessitates at the very least the most scrupulous care in connection with all matters relating to the accounts.

CIVIL LIABILITY OF AUDITORS.

In England there are two kinds of procedure under which civil proceedings may be taken against auditors for damages occasioned by negligent or unskilful discharge of the duties

imposed upon them—namely, by way of action, and by way of misfeasance summons.

In the United States the latter is, of course, in the absence of laws providing that a professional auditor could under any circumstances be an officer of a company, unknown, but the procedure by way of action is general. There are, of course, differences in practice in the various jurisdictions, but the procedure by way of action is believed to be practically the same.

As before mentioned, no American cases bearing on this subject have been found, and the English decisions will have to be considered.

PROCEDURE BY WAY OF ACTION.—One of the leading English cases under this procedure is the *Leeds Estate Building and Investment Society, Lim., v. Shephard,* which was decided by Mr. (now Lord) Justice Stirling in 1887. This case will be found duly reported in Appendix "A," and should receive the careful attention of the reader on account of its importance. The head-note of the official report is also of considerable interest; it reads as follows:—

"Held, that it was the duty of the auditor in verifying the accounts of the company, not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to inquire into its special accuracy, and to ascertain if it contained the particulars specified in the articles of association, and was properly drawn up to contain a true and accurate representation of the company's affairs."

That portion of the judgment which more particularly affects auditors enforces the same doctrine in even more definite terms:—

"In each of (these) years, L. (the auditor) certified that the accounts were a true copy of those shown in the books of the company. That certificate would naturally be understood to mean that the books of the company showed (taking, for example, the certificate for the year 1879) that, on the 30th April, 1879, the company was entitled to

'moneys lent' to the amount of approximately $150,000. This was not in accordance with the fact; the accounts, in this respect, did not truly represent the state of the company's affairs, and it was a breach of duty upon L.'s part to certify as he did with reference to them. The payment of the dividends, directors' fees, and bonuses to the manager actually paid on those years appears to be the natural and immediate consequence of such breach of duty; and I hold L. liable for damages to the amount of the moneys so paid."

The futility of an auditor attempting to escape his just responsibilities by a limitation of the scope of his certificate is here most forcibly demonstrated; there are, however, two other points, which must not pass unnoticed.

First, there was no question, in this case, as to the accounts being false. The matter in dispute was no moot question of depreciation, or of apportionment between capital and revenue; the accounts were indisputably false, and it was not even suggested that the auditor had done his best to verify their accuracy.

Secondly, the immediate result of his neglect was a payment of dividends, directors' fees and bonuses. Had no such result taken place, it is by no means so certain that any liability would have accrued.

Before dismissing this case altogether, it may be well to remark that the defendant was allowed the benefit of the Statute of Limitations; but—inasmuch as this point was not disputed by plaintiff's counsel, and was consequently not before the court—it does not follow that a like plea would avail upon another occasion.

Astrachan Steamship Company Case.—This was an action brought in the Palatine Court at Liverpool to recover damages from the auditors on account of loss sustained by the company through the dishonesty of its manager. A settlement was arrived at by the parties, so that no new point was decided as to the liability of auditors, but it may be mentioned in passing that the Vice-Chancellor expressed some doubt as to his jurisdiction to try the matter, and only proceeded upon

being satisfied that he did so with the consent of all parties. In this case a group of steamship companies were administered by the same manager, who was eventually adjudicated bankrupt with a large deficiency, and subsequently convicted for embezzlement. It appeared that he was able to satisfy the auditors as to the existence of the balance of cash in hand in the case of each company by producing to them a sufficient sum of cash, although it would have been impossible for him to simultaneously produce a large enough balance to cover the amount that ought to have been in hand in respect of all the companies that he managed. Apart from this, however, it appeared that he had made entries in the books of the Astrachan Company, showing that he had borrowed certain sums from that company at interest, and the suggestion was that a transaction of this kind was sufficiently unusual to make it the duty of the auditors to call the attention of the stockholders to the fact, more especially as—there being no board of directors—the stockholders were entirely dependent upon the auditor for protection.

POSSIBLE LIMITS TO LIABILITY.

It has already been stated that, in the cases quoted above, the measure of damages incurred by the negligent auditor has been the full amount wrongfully paid out in dividends. This raises the very important questions as to how far these cases can be relied upon as precedents in the event of the auditor's negligence being proved, but

(1) *No* dividend having been paid;

(2) A dividend having been paid, and the company having since gone into liquidation, but there being sufficient assets to pay all costs and all creditors in full.

It is hardly to be supposed that in either of these cases the auditor would incur *no* liability, but a very little consideration will suffice to show that a different mode of assessing damages would have to be adopted. It may be added here,

however, that although the practice of the English Courts has hitherto been to give judgment jointly and severally against all respondents held liable for the full amount of dividends improperly paid, with costs (without any corresponding right of contribution *inter se*), it by no means follows that this course will always be pursued. The language of Section 10 is "to repay the money or property . . . or to contribute such sums to the assets . . . as the Court thinks just."

In this connection the decision *in re Moxham v. Grant* * will be found of interest. Here the directors had been found liable to refund to the liquidator of the company certain dividends improperly paid out of capital, under circumstances which conveyed to the stockholders a knowledge of the nature of the source from which dividends were declared. It was held that the directors had a right to recover from the various stockholders the amount of their respective dividends.

To sum up, it does not appear that the conscientious and capable auditor, who has endeavored to conduct his audit upon the lines laid down in this work, need feel much apprehension as to the legal consequences arising from a *bona fide* error of judgment, or from his inability to discover an exceptionally clever fraud. On the other hand, it is doubtless greatly to the advantage of all properly qualified auditors if a reasonable measure of responsibility be expected from them, for there is then some chance of scaring out of the field a too numerous class of so-called auditors, whose extreme ignorance of the veriest elements of their profession is only equalled by their utter inability to appreciate the moral responsibility of their position. It is believed that abuses rarely occur, and that, consequently, all competent and reputable accountants may regard the matter as something that does not in any sense intimately concern them.

In order that the reader who is especially interested in the purely legal aspect of an auditor's responsibility may have the

* (Dicksee's Auditing, Seventh English Edition, page 689.)

benefit of the leading English cases, many of them will be found reported in Appendix "A."

The reported cases are preceded by a general summary, or rules, of the English law as laid down in these decisions, and until an authoritative American case appears the rules so deduced may be fairly considered as American law. This, at least, is the opinion of the attorney who prepared them.

It must be borne in mind, however, that the authors of this volume advocate far more rigid rules for professional auditors than the law seems to require. The rules of law are simply given for information and not as recommendations.

CHAPTER XI.

INVESTIGATIONS.

It has been thought desirable to devote a chapter to that special phase of the subject which is usually known as an "Investigation." The subject is one intimately connected with auditing, but possesses many peculiar features which cannot afford to be overlooked.

PURPOSES OF INVESTIGATIONS.

An investigation—so far as present purposes are concerned—may be described as "A special audit, undertaken for a particular purpose." The particular purposes for which an investigation is usually made are as follows:—

I. Upon the sale of an undertaking:

(*a*) To a public company.

(*b*) To a private purchaser, or purchasers.

(*c*) To a continuing partner, or partners, by a retiring partner, or partners.

II. For the purpose of obtaining special information as to the position of an undertaking:

(*d*) On behalf of a committee of investigation appointed by stockholders.

(*e*) On behalf of a present or prospective creditor.

(*f*) With a view to the discovery of suspected fraud.

The former group alone claims attention in this work.

EXTENT OF INVESTIGATIONS.

When making an investigation of any kind it must not be forgotten that those relying upon the accountant's report will naturally, and indeed reasonably take it for granted that, so long as they adequately explain their object in seeking his assistance, it is for him, as an expert, to decide both as to the nature and the extent of the examination itself; and in the event of its being subsequently discovered that an investigation had failed to achieve its intended object, the accountant would be required to show that such failure did not arise from any cause which could have been prevented by a more complete, or a more exhaustive examination. Cases are not unknown in which a faulty investigation has been attempted to be shielded under the plea that special instructions had been given by the client, and that such instructions had been duly carried out; it being argued that where the client has given special instructions as to the course to be pursued, the accountant must be exonerated from any mishap arising from the defectiveness of those instructions. This doctrine appears to be a most dangerous one. There can be no doubt that whatever instructions the accountant may have received were intended rather as a description of the object to be effected than as a definite requirement as to the means by which that object was to be attained. It goes without saying that the best authority as to the means to be employed must be the accountant himself (who receives his instructions by virtue of his being an expert in the matters requiring investigation), and it would thus seem that—however desirable it may be that he should receive, and even welcome, suggestions as to the *modus operandi* of his work—an accountant cannot submit his professional discretion to the dictation of his clients without sacrifice of self-respect and grave danger to his clients' interests. An accountant who undertakes the responsibility of an investigation ought not to seek to shield himself from the implied responsibility of proceeding upon that investigation on the lines which his professional experience convinces him are the proper ones.

The position of the investigating accountant, when only incomplete sets of books are available, is a question of very considerable importance. So long as the books are sufficiently complete to enable the accountant to reasonably arrive at the conclusion that (so far as they go) they are accurate, there can, it is thought, be no objection to his issuing a report confined to such matters as the books may show. But there is a danger of the whole system of investigation falling into discredit, if accountants go too far, and substitute for certificates of actually accomplished facts statements so qualified as to amount, in effect, to but little more than a carefully safeguarded expression of opinion. It should be borne in mind that the object of any form of accountant's certificate or report, included in a company prospectus, is to satisfy intending investors, and that such persons do not, as a matter of fact, by any means always carefully study the wording of the report, or certificate, referred to. Unless, therefore, an accountant has really something to certify he should studiously refrain from issuing any statement of opinion, or estimate, in the form of a certificate.

DETECTION OF ERRORS IN THE BOOKS.

Before proceeding to consider the subject in further detail, it would appear desirable to clear up a point which is of the greatest importance, and upon which a considerable difference of opinion appears to exist—viz., the position of the accountant who has certified as to profits which, in consequence of the falsification of the accounts investigated, have subsequently proved to have been overstated. There appears to be no decision directly bearing upon this point; but a case which came before Lord Kyllachy at the Court of Session in Edinburgh, in 1892, is of considerable interest. The case was that of the *Edinburgh United Breweries, Lim.*, &c., v. *James A. Molleson (Nicholson's Trustee)*, &c.,* and the question then at issue was as to whether the circumstance that the profits disclosed by

* Dicksee's Auditing, Seventh English Edition, page 620.

the books of the Palace Brewery, Edinburgh, were in excess of the amount actually made was (in the absence of fraud on the part of the vendors) a sufficient ground for the cancellation of the purchase, or for damages. It will be seen that this case has only an indirect bearing upon the point now being considered; indeed, the interest which it possesses is dependent rather upon the nature of the evidence than upon the point actually at issue. Especially must it be borne in mind that, although Lord Kyllachy's decision was upheld upon appeal, it was merely upheld because it was considered that the plaintiff had no right of action against the defendant, no opinion being expressed by the Court of Appeal upon Lord Kyllachy's views. At the original hearing of the case it was contended on the one side that books submitted to accountants for examination were to be taken as warranted free from falsification; while, on the other hand, it was argued that it was not the custom for any such warranty to be implied, and that a proper investigation of the accounts should have disclosed the fact that the profits had been, more or less, overstated. In giving his judgment, his Lordship stated that it appeared to him that the question was as to whether it was a condition of the contract of sale, expressed or implied, that the books of the brewery were to contain no errors, or, at least, no errors that were not easily to be discovered, and he confessed his inability to discover any reason for so holding. He could find no standard according to which the purchaser's examination of the books was to be conducted, and he was, therefore, unable to hold that the plaintiffs were entitled to re-open the contract, and now raise the question as to whether a condition as to the amount of profits had been fulfilled. The chief point in this decision which is really of interest in the present inquiry is the finding that there does not exist in a contract for sale based upon a statement of profits an implied condition that such statement is correct. Exception must, of course, be taken in the case of a fraudulent mis-statement, for naturally such contracts would be voidable upon proof of fraud. The question remains, however, that if the vendors have acted *bona*

fide there is no redress for the purchasers if they have given too large a price for an undertaking in consequence of an incorrect statement of profits by the vendors (provided the purchasers have had an opportunity of verifying such statement), or in consequence of a statement of profits that has been falsified—it may be by some employee of the vendors, unknown to them. It would therefore appear that, in such a case, an investigation that failed to reveal the actual condition of affairs would have failed to achieve its most important object. In the case of *Short & Compton* v. *Brackett* (*vide* Appendix "A") it was expressly decided by Judge Tindal Atkinson that an investigating accountant is entitled to "assume" the accuracy of the figures appearing in the books.

Opinions of Accountants thereon.—It is not proposed to fully discuss the legal position and responsibilities of an investigating accountant under such circumstances, nor to criticise the investigation that was made in *The Edinburgh United Breweries'* case; but as there is much that is deserving of attention in the various opinions that were expressed by the expert witnesses who appeared in that case, the opinions of these witnesses are shortly stated here.

Each of the following extracts represents the opinion of a different accountant:—

"There is a difference between checking books and investigating profits, and that an investigation of profits, even if properly conducted, would not always reveal an actual misstatement thereof."

"In making such investigations I do not consider it any part of my duty to go through all the books and vouchers as in the case of a regular audit."

"In investigating the profits of a business with reference to a sale, my experience is that an accountant is not expected to check the books and entries for the purpose of tracking falsifications. There is a marked difference between an audit and an investigation with a view to profits. The falsifications in this case could not have been discovered without a comparison of the postings in one set of books into another, and I hold that is no part of the duty of an accountant turned

on to investigate profits. Personally, I always insert the words 'assuming the accuracy of the books' in my certificate."

"It is not the custom in such cases to examine the books in detail. Accountants consider that they are entitled to assume the genuineness of the books."

A leading solicitor expressed the opinion that accountants, when instructed to investigate into the profits of a company, were not expected to go into such details as would have been necessary to discover the falsifications in this particular case.

On the other hand:—

"A proper examination would have discovered the falsifications; I consider that an accountant pursuing an investigation that would be useful would wish to *analyze* the accounts, and if this had been done the frauds would have been discovered."

"The falsifications should have been discovered; I consider that an examination of the individual (trade) accounts was necessary to form a correct idea of the nature of a business, and had this been done the frauds would have been discovered."

It is altogether likely that if expressions of opinion upon this case were requested from the same number of American practitioners the answers would correspond very closely with those quoted above, *i. e.*, support would be given to both sides of the controversy.

In speaking of the object of these examinations, the writer of an article that appeared in *The Accountant* at the time says: "What the public seem to want is, not the nearest approach to facts that can be obtained in so many days or weeks, but the nearest approach to facts that is humanly possible." This will be found to accurately express the views of the average layman.

INVESTIGATION ON BEHALF OF PROJECTED COMPANY.

(*a*) For the purpose of pursuing this inquiry in further detail, it is proposed to narrow the field down to the question of investigations made on behalf of a projected company. The

following suggestions will, therefore, also cover sub-heading (*b*). The most convenient method of dealing with the subject will be to contrast the methods to be adopted in such an investigation with those ordinarily employed in a regular audit.

From a theoretical point of view there need, of course, be no difference of method; for both audits and investigations aim at a complete disclosure of the facts. In practice, however, it is usual to restrict the inquiry, so far as is possible, without imperilling the efficiency of the examination; and it is because the objects of an audit are not altogether the same as those of an investigation that the method adopted in each case—*i. e.*, the abbreviated, practical method—varies somewhat.

LIMITS OF AN INVESTIGATION.—A regular audit professes to discover the true position of affairs. An investigation as to profits, made on behalf of a proposed company, professes to discover the position of affairs so far as they affect the particular object in view. In some respects the narrower field of an investigation will permit the accountant to reduce the scope of his examination; but, on the other hand, there would appear to be many points upon which a greater strictness of inquiry is necessary. Thus, supposing the accountant to be acting upon behalf of the purchasers of an undertaking, he may take it for granted that the accounts submitted to him by the vendors do not underestimate the profitable nature of the business, or the strength of its financial position. Consequently, it does not seem necessary that he should inquire with the same exhaustiveness that he would use in the case of an audit into the completeness with which every source of income has been duly accounted for; neither does it appear necessary for him to consider the validity of the various items of expenditure charged in the accounts, nor to compare such expenditure minutely with the vouchers. On the other hand, if he is acting on behalf of the vendors, it is clearly desirable that both these points should receive careful attention, but in that case the investigation would not differ

greatly from the complete audit; for it is obvious that he could not authorize the submission of accounts to the proposed purchasers until he was satisfied that such accounts were true in all respects.

FRAUD IN ACCOUNTS.—Yet another difference between investigations and audits will not fail to strike the observer. An ordinary audit must always aim at the discovery of fraud; but an investigation as to profits would not appear to involve any such inquiry, except in so far as the assets or profits might have been fraudulently overstated for the purpose of concealing defalcations, or of deliberately making the accounts appear unduly favorable.

Broadly speaking, there are two ways in which books may be falsified for the purpose of concealing fraud. The first method is by falsifying the balance sheet, either overstating assets or understating liabilities to cover the amount stolen; the second method is by falsifying the revenue account, by understating income or overstating expenses, so that the profit shown by the books may be reduced to the profit which was actually netted by the proprietors, after deducting the amount misappropriated by the defaulter.

If the first method has been adopted, the purchasers will not necessarily be prejudiced, for the profits shown by the books will have been the profits actually made; while the assets which appear in the books at an unduly inflated price will usually be guaranteed as to the value by the vendors, or else vouched for by the certificate of an independent valuer. Sometimes, however, the investigating accountant assumes responsibility for the accuracy of the scheduled book debts taken over by the proposed company, and in such cases it will, of course, be necessary for him to carefully inquire into their correctness.

On the other hand, the defalcations, if considerable, are likely to be concealed by a falsification of balance sheet items rather than of revenue items, for any material understatement

of profits, such as would be involved by the last-named form of falsification, would be extremely dangerous, as drawing prominent attention to the existence of a leakage. A falsification of balance sheet items, with a view to concealing defalcations, ought not to escape the attention of the investigating accountant; not, of course, because he is necessarily responsible for the values attached to the various assets and liabilities in the balance sheets of the undertaking about to be purchased, but because he cannot safely include, in his certificate of past profits, profits actually earned by the undertaking which, owing to the dishonesty of its employees, never went into the pockets of its proprietors.

Under the second method it would appear that the purchasers would actually gain by the defalcations of an official of the vendors, for the profits earned would be in excess of those shown by the books, while the latter would form the basis upon which the purchase price for goodwill was calculated; and, as the balance sheet would correctly record the financial position, there would obviously be no injustice done to the purchasers, if these figures were taken as a basis for valuation. It is thought, therefore, that the investigating accountant acting on behalf of a proposed company need not trouble to go exhaustively into the question of the *bona fides* of the various expenses debited, his great object being to make sure that the expenses are completely recorded in the books submitted to him. On the other hand, he will require to look carefully into the *bona fides* of many transactions, which the auditor would naturally pass either unquestioned, or, at all events, after due representation of the circumstances to his clients. The difficulty of the investigating accountant's position arises from the fact that his real clients (*i. e.,* those in whose interests he is acting) are an unknown, and, at that time, non-existent body. It is, therefore, obviously impossible for him to consult them in any way during the course of his investigation, and his only means of acquainting them with the result of his inquiry will be by means of his certificate.

SCOPE OF CERTIFICATE.—In making an investigation as to profits, therefore, the accountant must be careful never to lose sight of the object for which his investigation is being made. That object may be said to be to ascertain

(*a*) Whether the business of the vendors is worth purchasing.

(*b*) Whether such business is worth the price asked for it by the vendors.

The accountant is not actually asked to express a definite opinion upon either of these points, for it is obviously the business of each intending stockholder to answer these questions to his own satisfaction before applying for shares, but it is pointed out that the accountant's certificate forms almost the sole basis upon which the stockholder can judge of the prospects of the proposed company, and it is therefore argued that it should be the accountant's aim to so conduct his investigation, and so frame his certificate, that the materials necessary for a correct judgment may be placed before the public. At the same time it cannot be too strongly insisted upon that an accountant's certificate as to profits, relating as it does to past events, deals with a subject-matter that ought to be capable of absolute verification. The certificate, therefore, should be a clear and unconditional certificate of accomplished facts, and not a mere estimate of possible—or even probable—future results, misnamed a "certificate." To the limited extent already mentioned it may be permissible, and even desirable, to modify the past results so that they may more usefully serve the purpose for which they are primarily intended—namely, provide a reliable index of future profits. But at the same time a certificate should relate not to the future, but to the past; and intending investors would do well to bear in mind that, unless a definite statement as to the past *is* provided in a company prospectus, the reasonable assumption is that the past profits have been unsatisfactory.

There is yet another point which the accountant must not fail to bear in mind. Inasmuch as he may be required at any future date to substantiate the statements that he has certified, he should not fail to make the most copious notes of all that transpires during the course of his investigation. These notes should not be confined to actual figures and calculations: whatever explanations he may have received in reply to his inquiries should be committed to writing, so that they may be available if required. If this be not attended to, and legal proceedings are subsequently instituted requiring the accountant to substantiate his report, his position will not be an enviable one, for he will probably have to go over at least a portion of the ground a second time, and perhaps some of the evidence he formerly utilized may no longer be available.

LENGTH OF PERIOD TO BE INVESTIGATED.—It is generally held that it is no part of the accountant's duty to prescribe the term of years over which his inquiry should extend. It is, however, desirable to bear in mind the importance of expressly stating in the certificate the period that has been covered by the investigation; and, further, it is absolutely essential that the inquiry should be brought reasonably up to date. It may be found convenient to report only upon the results of completed years, but the odd months elapsing between the date of the last balance sheet and the date of the investigation should not escape notice, and if they show any material falling off, the fact ought not to escape attention. It may be added here that it is very desirable that the accountant's certificate should separately state the profits of each year covered by the investigation.

METHOD OF PROCEDURE.—STANDING OF VENDORS.—Before actually commencing an investigation it is very desirable to make inquiries as to the position and character both of the promoters and the proprietors of the undertaking. A man is always apt to be known by the company he keeps, and no one can afford to be mixed up with persons of more or less doubtful reputation. Moreover, if a man bears a really bad

character, it may safely be taken as being as least probable that the company in which he is concerned is not likely to prove a very good investment to the public; and an accountant is not likely to do himself much good by mixing himself up with unprofitable companies.

System of Accounts.—The next point that claims attention is the general system upon which the books have been kept. And, in this connection, it may be mentioned that—inasmuch as it is very desirable that the accountant should secure the co-operation of the employees of the establishment—it is a mistake for him to abuse the system of accounts which he finds in use, in the presence of the bookkeeper. Any such want of tact upon his part is almost certain to put the bookkeeper's back up, and then, instead of information flowing in smoothly, it has to be dragged out by a course of cross-examination that involves a heavy expenditure of both time and temper.

Audited Accounts.—If the books have been regularly audited by a Certified Public Accountant it is a good plan to seek an interview with him, and endeavor to gather the precise extent of his examination, and also his general opinion upon the matter. This course is, perhaps, somewhat unusual; but clearly it cannot be regarded as objectionable, while cases may easily arise in which it might be a most useful course to adopt. For instance, if a thorough audit has been made at regular intervals by a competent and trustworthy accountant, the investigating accountant might feel fairly safe upon most matters of mere arithmetical accuracy, and confine his attention more exclusively to questions of principle and to values.

Unaudited Accounts.—On the other hand, if there has been no regular audit, and *a fortiori* if the books have not even been regularly balanced, it seems as though he could not, with safety, neglect an absolutely exhaustive inquiry into all the facts. Of course, objections may be raised to this position, the most important being the objection that such a complete

examination would occupy a much longer time than is ordinarily available for the purpose. It is, however, submitted that it is the accountant's duty to make an effective investigation—not the most effective investigation practicable in a limited period of time—and further, that he should so conduct affairs that he need not shrink from accepting the fullest responsibility as to the extent of his investigations.

NECESSITY FOR INSPECTING BALANCE SHEETS.—Another general point to which it is desirable to draw attention is the danger of looking only to the revenue account for information as to profits. Cases are not unknown in which—the assets being taken over at an agreed valuation—the investigating accountant has confined his attention entirely to the revenue account, without concerning himself with the sufficiency or otherwise of the amounts written off for depreciation and bad debts; the result being that the certified profits "as shown by the books" were greatly in excess of the profits actually earned. The accountant who aims at something more than pocketing his fees and keeping his skin whole will not rest satisfied with that sort of investigation.

GENERAL COURSE OF PROCEDURE.—Assuming that the accountant is about to commence an investigation into the profits of a manufacturing or trading concern during the past three (or more) years, with a view to its being purchased by a private individual or a corporation; the land, buildings, plant and stock-in-trade being specially valued for that purpose by an independent appraiser; assuming further that the accounts have been continuously audited by a firm of Certified Public Accountants, who are satisfied as to their correctness, the question arises, What special points will the investigating accountant require to examine which do not arise in the ordinary course of a regular audit?

Taking first the several revenue accounts, he will compare these with each other, and see whether or not they indicate a steady or consistent condition of affairs, whether the turn-

over fluctuates materially, is increasing, at a standstill, or diminishing; whether the percentage of gross profit is fairly constant, and such as is usually earned in such undertakings; and whether the percentages of expenses and net profit to gross turnover are reasonably steady. A marked reduction of expenses during the last year must be viewed with the greatest suspicion, for such reduction, if excessive and not *bona fide,* may have a very serious effect upon the future prospects of the undertaking.

So far as is reasonably practicable, the accountant must examine the *bona fides* of all sales, especially those recorded during the last few months. The prices of at least a portion should be compared with current rates, and any remarkable increase in the amount of sales or in the number of new accounts opened should be regarded with suspicion. All entries "on approval" must be disallowed, and where sales are post-dated it seems essential to make sure that they have actually gone out of stock. The entries for the next few weeks after the closing of the books should be carefully scanned, and if they show an exceptionally large number of returns, or an exceptionally small amount of sales, he must draw his own conclusions as to the *bona fides* of such entries. In dealing with the question of consignments, he must remember that the goods have probably been invoiced out at selling prices, while the unsold balance can only be allowed for in the accounts at cost price (*plus* expenses) at most. Another point which must not be lost sight of is the question of travellers' commission; care must be taken to charge up commission upon all sales that are included in the accounts. Due allowance must also be made for all outstanding accounts. Due allowance must also be made for all outstanding discounts; and empties which are returnable, but not yet returned, cannot safely be taken credit for at the full price charged.

With regard to the purchases, the problem is similar to the sales, but somewhat simpler, because the accountant can usually get hold of the creditor's statements. It is, however, very

necessary to be on ones' guard against the omission of post-dated invoices when the goods have actually gone into stock.

Where reliable stock accounts and cost accounts have been kept, there exists a very valuable corroboration of the contents of the trading account; but where these cannot be obtained, the accountant must do his best with the material available.

It is especially important that the various stock takings should be conducted upon similar lines, *i. e.*, they should be based upon the same scale of prices, due allowance being made for the depreciation of articles no longer in fashion, or in small quantities, or "odd" sizes.

If the various stock lists have been prepared upon different scales of prices, they must be recast upon a uniform method, as any such difference may very materially alter the profits shown by the accounts. The valuation of the stock-in-trade made by the appraiser should be compared with the vendor's stock list, and if there is any material difference between the two, the accountant must not fail to examine the effect of such difference upon the accounts. Thus, supposing he arrives at the conclusion that throughout (say) the past three years, the stock has been consistently overvalued, say, 15 per cent., and supposing the stock is $50,000 heavier at the present time than it was three years ago, then during those three years the net profits will have been overstated $7,500 or (say) $2,500 a year, which is a material difference when one comes to pay eight or ten years' purchase for a goodwill.

When the stock consists of such articles as cotton, iron, grain, lead, &c., which have a definite but unstable market value, the question of the legitimacy of profits arising from such alterations in value as may have occurred is a consideration of no slight importance. This is a point upon which the author would rather not express too decided a view at the present time, but it is his opinion that (1) no profit should be taken credit for upon the rise in value of unsold stock,

although revenue must be debited with the contingent loss arising from any fall; (2) no profit should be included as part of the trading or manufacturing profits that has arisen out of a "gamble" pure and simple, but that gambling losses cannot safely be ignored; (3) where any material portion of the profits has arisen from favorable fluctuations of value—as opposed to true commercial profits—it is very desirable that the two sources of profit should be distinguished in the accountant's report.

If there are any further items to the credit of the profit and loss account, he will require to see that the profit has been actually netted, and that it is fairly incidental to the business of the undertaking. Even then, however, a purely exceptional source of profit (*e. g.*, the fact that an important exhibition had been held in that particular industry, or an altogether exceptional contract executed) should always be specially noted in the report.

Another point of no slight importance may be mentioned here, although it does not immediately arise from the preceding considerations. Where the undertaking is of such a nature that it cannot be advantageously carried on except in the present premises, the accountant should satisfy himself that those premises will be conveyed to the company for a reasonable term. No sensible man would buy the goodwill of a hotel unless he could get a long lease, if not the freehold, of the hotel premises; while the goodwill of a music hall held on a yearly tenancy would not usually be considered a good investment. If the lease to be granted to the company is at an increased rental, he must on no account forget to mention the fact.

Turning now to the expenses debited to profit and loss account, the accountant will require to satisfy himself that every legitimate expense has been actually included. The ordinary current expenses present no especial difficulty; if the accounts for the past three years, or more, are available

they will show these fairly well, while a study of the accounts since the date of the last balance sheet will probably disclose any outstanding liabilities that have been improperly omitted. Attention has already been called to the danger of a *mala fide* ruinous curtailment of expenses, so there is no occasion to again dwell upon that point.

There remain now the questions of bad debts, repairs and renewals and depreciation. For the purpose of dealing with these points the accountant must refer to the balance sheets, as well as the profit and loss accounts; and, inasmuch as he is no longer in the realm of cut-and-dried facts, he must use the greatest amount of circumspection in arriving at his ultimate opinion.

In dealing with bad debts, the circumstance that he is dealing with at least three years' accounts will help him to a certain extent, for it will enable him to strike an average, and he can compare that average with what his experience teaches him to be the average usually obtaining with similar classes of undertakings. Again, the book debts of the first year, at least, are almost certain to be either collected or else written off before the end of the third year, and he can compare the percentage of the first year's actual bad debts upon its sales with the percentage written off each year. Such a comparison is of necessity only tentative, but it is useful so far as it goes. Then he can carefully examine the last schedule of book debts; the chances are that he will know a very appreciable proportion of the names there set down, and if he finds that the schedule contains names that some of his other clients look upon as bad or doubtful, he must draw his conclusions accordingly, to the best of his judgment. In any case, and under all circumstances, he will require to satisfy himself that a sufficient provision for bad and doubtful debts has been debited to revenue.

With regard to the question of depreciation, his position is, perhaps, a little more difficult. Speaking generally, if the

values set forth in the balance sheet submitted to him exceed the amount of the appraiser's estimate, he may add such difference to the amount of the depreciation debited to revenue during the period under review. The method is not infallible, however, for the valuation at the commencement of the period may have been too high—in which case he will be charging an undue amount against the profits of the current period; or it may have been too low—in which case he will not have charged enough. There are, however, normal rates of depreciation which may be used to verify results, and previous experience, combined with sound judgment, will probably keep him from going very far wrong. Repairs should in all cases be charged up to revenue, but actual renewals need not be, provided *due* allowance has been made for depreciation.

If part of the assets taken over consists of shares in other companies, care must be taken to see that these are included in the accounts at their proper value. Where shares (perhaps unquoted shares) have been received in payment of book debts, especial attention is necessary, as the trading results are directly affected. Under no circumstances should revenue be credited with more than normal value of the work done until the shares have been actually sold, and if the profits realized on such shares form any appreciable portion of the total profits the accountant should mention the fact in his report.

Where patents form part of the proposed purchase, and where such patents have not been submitted to a specialist for valuation, the accountant should make it his business to see—so far as possible—that the inventions purchased are actually protected. In a recent case, a so-called patent that had been purchased by the original proprietors of the undertaking in perfect good faith was not really patented at all.

ADJUSTMENTS IN PROFITS.—For the purpose of a certificate attached to the prospectus of a new company it is usual to make certain adjustments in the statements of profits which would not ordinarily appear in the accounts of a going

concern. This arises out of the difference between an investigation and an audit, the former being primarily with a view to verifying the revenue account (and so certifying the *normal* profit of the undertaking), while the latter is—speaking generally—confined to a verification of the present position of affairs, as shown by the balance sheet. In order to avoid any possibility of misconception, however, it is well to invariably state what adjustments have been made in connection with profits which would not be usual in the case of a going concern.

These adjustments would, in all ordinary cases, include the amounts paid for interest on capital, interest on loans, and partners' salaries, which may all properly be added to the net profits, provided the fact that they have been added is clearly stated. There are, however, other points which are possibly more debatable, and which will now be considered.

Depreciation.—Under normal circumstances a certification as to the net profits would naturally assume that a reasonable amount had been written off such profits in respect of the depreciation of all assets necessary for the purpose of carrying on the business. It sometimes happens, however (especially where a large number of retail concerns are amalgamated, for the purpose of forming one large company), that the accounts which have to be investigated are incomplete, and that no reliable information can be obtained as to the actual value of the assets upon which depreciation ought properly to be charged; while it may be added that the normal depreciation would naturally to a large extent be based upon the actual cost of such assets to the present proprietors, whereas the depreciation which will have to be charged by the proposed company in the future will of necessity have to be based upon the amount which that company actually pays for the assets in question. Under these circumstances—and under all other circumstances where the same conditions apply—it is not merely difficult to assess the actual rate of depreciation, but sometimes actually misleading to deal with it, even where

it can be assessed. That being so, it is thought better, where these conditions apply, to certify the amount of profits which have been earned *without* any provision whatever for depreciation, leaving the assessment of the amount necessary to provide for this contingency to those who may be interested in the matter.

CASH DISCOUNTS.—Where the concern in question has hitherto been hampered by want of capital, and has therefore not been able to take full advantage of the cash discounts offered, it may be urged that it is permissible, where the scheme of the proposed company provides for sufficient working capital, to take credit for the maximum cash discounts that might have been obtained, had ample working capital been employed, but it is questionable whether this is good practice, as it is introducing a factor which is largely problematical, as the discounts have not actually been realized in the past and there is no certainty of their being actually realized in the future. A supplemental note stating the estimated amount which could have been obtained had ample capital been employed would be preferable to including the figure in the statement of earnings.

EXCEPTIONAL LOSSES AND PROFITS.—It has already been indicated that the main object of any investigation is to arrive at the normal profits of an undertaking; and, that being so, it is important that any exceptional sources of profit should be excluded, while *per contra* it is permissible that wholly exceptional sources of loss should be excluded. It is very difficult to define exhaustively either profits or losses coming under this category, but the following may be included.

EXCEPTIONAL LOSSES.—Losses not covered by insurance arising through fire, accidents to employees, or defalcations; provided a sufficient charge against profits is made to cover the amount which such insurance would have cost. Losses arising through actions at law not altogether incidental to the carrying on of the business, as, for instance, through breach

of contract, infringements of patents, &c.; but, if the losses arising from these causes are excluded it is essential that whatever profits may have been earned in connection with the subject matter of the action should be also excluded, unless the litigation resulted in favor of the proprietors of the business being investigated.

Under the heading of EXCEPTIONAL PROFITS which ought to be excluded may be classified all such transactions as it is not reasonable in the ordinary course of events to anticipate will frequently *recur* in the carrying on of the existing business upon ordinary lines. It is naturally impossible to deal exhaustively with this class of item, but the following headings may be mentioned:—

(1) Any profit received from a municipality or railway, by way of compensation for compulsory removal of the business premises.

(2) Any profit received from an insurance company in respect of a risk covered by a policy of insurance.

(3) Any profit received in connection with the sale of a portion of the undertaking, as, for instance, the sale of a patent, or of certain limited rights to work a patent, or of any fixed assets that may have been acquired for the purpose of working any portion of the concern in question, whether that department may since have been abandoned or not.

Generally in matters of this description there is always a temptation to emphasize the saving which may be effected in the future by more skilful management, and by the economy which might reasonably be expected to result from the amalgamation of several concerns. These, however, are matters which, it is submitted, ought not to form the basis of any accountant's certificate as to profits—as a matter of fact most of the promises of this character which were held out on the flotation of many large industrial combinations a few years ago have not been realized, but, on the contrary, extravagance in

management seems to have resulted in many enterprises which prior to consolidation had been most economically administered. Such certificate should be rigidly based upon facts, and although certain adjustments, as already indicated, may be desirable (and even necessary), so that a correct impression of these facts may be gathered, in view of the altered conditions which it is expected will obtain under a new company, under no circumstances whatever should the certificate as to profits degenerate into anything which could possibly be described as an estimate, or a guess of what may under certain circumstances be expected to happen in the future.

CONCLUSION.—By this time the accountant will have arrived at an opinion as to the amount of profits ordinarily earned by the undertaking he is investigating, but his work does not quite end here. In practically all cases an accountant pursuing an investigation that would be useful would wish to analyze the accounts. Not only is it thought that such a course is most desirable as a safeguard against fraud (where a regular and satisfactory audit does not practically remove this contingency from the sphere of possibilities), but it is also extremely valuable for revealing the general nature of the business under review.

The accountant will now have collected sufficient data to enable him to form a fairly complete impression of the business which he has been investigating. He will have had ample opportunity to study the general mode upon which the business is conducted, and he will have formed his own opinion of the *personnel* of the management; he will have ascertained the amount of capital required to conduct the business upon its present lines, and have formed his own opinion as to the scope it offers for an increased capital (if such a thing be contemplated); he will have ascertained how far the continued success of the undertaking depends upon: (*a*) successful competition; (*b*) the continuance of a monopoly; and (*c*) the caprice of public demand; and have formed his own opinion concerning their continuance. In a word, he will be able to gauge the

probable success of the venture. The point now to be considered is how far, if at all, his personal opinion upon these points should influence his report.

If it be conceded that the object of the accountant's investigation is to supply the place of an independent examination by each proposed stockholder (as the object of a professional audit is to supersede and supply the place of a personal examination by each proprietor) it must be admitted that these opinions are entitled to some expression. Yet the expression of personal opinions should be cautious and not dogmatical, and should be very clearly separated—where expressed at all—from professional opinions given, as experts, in matters of account; and further, it should never degenerate into either estimates or prophecies. It is very difficult to lay down any general rules upon this point; but, so long as the question is considered upon its merits in each particular case, the accountant will probably not get far wrong.

Care must be taken that where the accounts of a group of undertakings are reported upon, and where they have been so closely allied that future operations would require each property to be taken care of, that a consolidated balance sheet and consolidated earnings statement be submitted. Cases have been known where separate reports have been made on each of a group of properties, and use had been made of the statements of the profitable undertakings, while the unprofitable ones have been suppressed—although an intending purchaser would have to operate the losing as well as the profitable enterprises.

(c) Upon the Sale of an Undertaking To a Continuing Partner, or Partners, by a Retiring Partner, or Partners.

There are several features connected with this heading which require special attention.

A "continuing" partner may also be a "liquidating" partner in cases where the death of his partner was the moving cause of retirement, or the retiring partner may be withdraw-

ing from the business on account of sickness, old age, or some other indisposition. In each of these contingencies the continuing partner is charged with a much greater limit of responsibility than the vendee occupies in any other position, and it is therefore incumbent upon the auditor, who may be called in to represent either or both sides, to make a somewhat more thorough investigation than is necessary in (*a*) or (*b*).

Usually the auditor will represent the retiring partner or his representatives, for the continuing partner may be depended upon to look after his own interests. We will, therefore, proceed to discuss the procedure where the auditor has been retained to ascertain the exact financial condition of a concern as at a certain date, and where there are no provisions in the partnership agreement regulating the basis of values at which the assets shall be taken.

As a rule the accuracy of the revenue account is not so important as the balance sheet in such an investigation, although, of course, use must be made of the statement of profits wherever the value to be placed upon goodwill is based thereon.

Generally speaking, all of the work required of an auditor who is investigating for an intending purchaser will be required to be done for the seller in this case, but we will now proceed to discuss certain further duties. The valuation of the assets should be upon the basis of a going concern, and it devolves upon the auditor to see that they are not undervalued. Obviously, the continuing partner should on his own initiative, even if the representatives of the retiring partner do not suggest such action, secure the services of independent appraisers, who, after being acquainted with the facts, should proceed with their work, having due regard to the rights of each partner.

In many cases, however, no such action is taken, and the surviving or continuing partner liquidates the business and places his own values upon the assets. It is difficult to lay

down any definite rules for him to follow, but it must be observed as a general maxim that in all cases where doubt exists as to values, the absent partner should have the benefit of such doubt. The reason for this is clear, for it must inevitably be true that the continuing partner will be fully alive to all of the advantages which according to his way of thinking belong to him, while on the other hand, death or absence having closed the lips of the retiring partner, his rights, if not clearly set forth, may escape attention entirely.

It is a well-known rule of law that a liquidating partner must not take the slightest advantage of his position, and this fact alone would compel him to settle all doubts in favor of the absent partner. Probably the most difficult point to decide will be the value of the stock-in-trade, and as each case, of necessity, must stand on its merits, no general rules can be laid down.

Nevertheless, it can be observed that the ordinary conservative rule of pricing stock at "market or cost whichever is the lower" cannot possibly apply here. The liquidating partner is bound in law and equity to realize the highest possible price for anything he may sell, and if he is selling to himself he is assuming the responsibility of putting himself in a position where he says to the world that he has given more for the stock than any one else would have given. In other words, he declares himself to be the highest bidder. This, of course, does not mean a bidder at forced sale, for if the goods have never been offered to the public it is manifestly impossible to put a forced sale valuation upon them. The equitable valuation would probably be the cost of duplicating the entire stock as at a certain date, after allowing, perhaps, for "dead" or unsaleable stock. The latter, however, is a dangerous doctrine, for the buyer has elected to take the business as it stands, and he should not be allowed to stipulate that part of the stock is good and part bad.

If the stock consists of staple goods ascertaining the cost of duplication should not be unduly difficult, and if the goods are

made to order, or the values difficult to estimate, it would seem that the fairest way to secure the valuations would be, wherever practicable, to trace the sales, and by applying the current rates of gross profit thus secure a basis of cost. The accuracy of this would have to be tested, but there should be no difficulty in making the tests.

If an agreement were reached to take the stock at cost, it should be borne in mind that the proper interpretation of the word "cost" in this case would be the original price paid plus all charges down to the date of inventory. It is contended by some accountants that these charges include not only freight, insurance, storage, handling, rent, &c., but also interest down to the date of inventory. The contention as to interest is rather a nice question but as it may certainly be classed among the doubtful items, the general rule applicable to this class of cases would seem to require that the point should be decided in favor of the retiring partner.

The question of the valuation to be placed upon fixtures, &c., should be decided generally upon the lines laid down above. For the sake of convenience, cost less proper depreciation, would seem to be fair.

Regarding book debts, stocks, &c., the usual custom of "working them out" should be followed. No commission or other compensation to the continuing partner can be allowed for this, but the actual cost of clerical help is a proper charge.

Of course, the retiring partner is entitled to or responsible for his share of the profits earned or losses incurred in the carrying out of contracts executed before the date of dissolution or winding up. Necessarily all of the expenses of such contracts up to the time agreed upon have been charged to the business; therefore, it would be obviously unfair to the retiring partner to have to pay his proportion of the expenses of making a sale and then be deprived of any share of the profits. This applies with equal force to losses; the continuing partner is not liable for anything beyond his own share of

losses incurred in executing contracts entered into in good faith prior to his purchase of the business.

It will be noted from the above that all of the expenses for a reasonable period prior to dissolution should be carefully examined to see that none of them are prepayments or apply to the subsequent period. As a matter of course the retiring partner will have to bear his full proportion of all liabilities, and it can be depended upon that all expenses chargeable to the old period, no matter how long afterwards they be presented, will be charged back where they belong.

Another point which will bear watching is discounts and other allowances granted upon book accounts. It may happen that a customer will return goods, upon which claim has been made, and these goods will, of course, not be found in the inventory. In ordinary cases they would be carried into the current stock of the *new* business, and it is quite likely that they would be overlooked. A careful analysis of all credits to the old customers, other than cash, would, of course, reveal the returns.

Many other points, such as partners' salaries, interest on partners' accounts &c., will require attention, but it is believed that the above suggestions will suffice to put the auditor on his guard and enable him to sufficiently protect the interests of his client.

The question may very possibly be raised that the accountant who pursues the course here advocated is not likely to enjoy a very extensive investigating practice. It is thought that this conclusion offers an injustice to company promoters as a class. The profession of a company promoter is a mixed one, doubtless, but the black sheep—although naturally the most notorious—are decidedly in the minority, and there are very many promoters who would thoroughly appreciate a greater strictness in investigations, which could not fail to strengthen the confidence of the public in corporate enterprise as an advantageous mode of investment.

CHAPTER XII.

INTEREST.

Every accountant has in the course of his experience probably had occasion to note the lack of uniformity in the methods of calculating interest. For this reason it has been thought well to insert a short chapter on the various bases of calculation and the relative propriety thereof.

In every calculation of interest there are three factors, *viz.*: principal, rate and time. With regard to the amount on which interest is to be calculated, *i. e.*, the principal, no question can well arise as this amount must be definitely fixed beyond the exercise of any discretion in the matter before a calculation can be made. The rate—usually, though by no means invariably, expressed on a per annum basis—is indirectly affected by the stating of the time or period for which the interest is calculated, but in itself is really only capable of one application. It is with regard to the third factor mentioned—that of time—that the greatest divergence of method is found. Hence, it is in order to note the different ways of stating the time in a given period for which the interest is to be calculated, with the related question of the unit period of time on which the calculation is to be based.

A question on which there has been much debate and difference of opinion and on which there is a divergence in the usages of financial institutions is whether both the first and last days, or only one of them, should be included in stating the time included between two given dates. The following extracts from a digest on the subject from a legal standpoint are of interest (see 49 L. R. A. pp. 193-248):

"There seems to be one general rule with reference to counting the first and last days in the computation of a period of time which, subject to exceptions based upon the language of the provision for time or upon the surrounding circumstances, seems to have remained the same throughout the whole period of the common law, and which remains practically the same under the statutes and rules of court. That rule is that in the computation of time one of the first and last days of the period shall be included and the other excluded. The question as to which of the two days shall be included and which excluded, however, has been differently decided in different periods and different jurisdictions, and has given rise to much conflict of opinion. The general common law rule as it originally existed was that the first day was to be counted when the computation was to be from an act or event, but that it was not to be counted when the reckoning was to be from a day or from the day of an act or event. The more modern decisions have changed this rule and in the absence of a statute or rule of court controlling the question. the courts now compute time, as a general rule, by excluding the first day and including the last day.

". . . the general rule now existing, whether at common law or under the statutes, probably is that the first day of a period of time is to be excluded and the last day is to be included, but that either or both days may be either included or excluded, if the language of the provision for time is such as to require it, or if by so doing a penalty or forfeiture will be avoided."

With particular reference to negotiable instruments:—

"The general rule under the statute, as well as at common law, is that in computing the time that a note payable at a future day has to run, this day of the date is excluded.

". . . in computing the time when a note or bill payable at a certain number of months after date will become due, the rule is to exclude the day of the date from the computation,

and include the day of payment when no days of grace are allowed, and the note will become payable on the same day of the stipulated month as that of its date.

". . . a usage of banks to include the day of the date of a promissory note in their computation of the time when it becomes due will be recognized only as evidence of the assent of the parties to such usage and of their waiving their legal claims, and not as forming rules for the decision of the court (Blanchard v. Hilliard; 11 Mass. 85)."

It will be noted that the foregoing statements as to negotiable paper relate more directly to the determination of the time as affecting maturity or due date of an instrument than to the time for which interest shall be paid thereon. It would seem, however, that the same rule would apply to the determination of either question and that if a note is drawn at three months the interest thereon should be paid for a period of three months, no more and no less.

The practice among banking institutions in calculating interest or discount on loans varies, some including both day of date and due date, others only one of the two, while still others pursue a middle course by including both days when a loan is first made but only one of the two days on renewals. It will be observed that where the practice is to include both days it results in charging interest twice for the day on which a renewal note is given to take up the one maturing. The argument usually advanced to justify this duplication is that the result would be the same if the borrower were to obtain a loan at another bank (paying interest for both days) and use the proceeds to pay the maturing note.

Several cases bearing on these points which came before the courts many years ago merit consideration, though it will be noticed that the decisions are directly opposed to each other.

In 1829 the Supreme Court of Vermont heard the case of *Bank of Burlington v. Durkee* (1 Vt. 399), in which the circumstances were as follows:

A note for $2,000 payable 64 days from date had been discounted by the bank, the interest charged thereon being 64 days on the basis of 360 days to the year, $21.33. The defendant claimed that as the interest at 6 per cent. (the highest rate permitted by the law of the state) on a 365-day basis would only amount to $21.04, and there being no statute legalizing the 360-day basis, the bank had taken usury amounting to 29 cents. The contention of counsel for the bank in attempting to refute the charge of usury introduced into the case the question of the right to charge for both the first and last days of the period, stating that:

"The discount received by the bank was $21.33, being the interest on $2,000 for 64 days at the rate of 6 per cent. for 360 days. Now, inasmuch as the borrower received the money on the day of the discount, and was not liable to pay the same until he had the use of it for 65 days, including the day of discount, the bank had a right by law to take interest at the rate of 6 per cent. per annum for 65 days, which would in fact exceed the interest taken by 4 cents."

The court, however, ruled that it was unlawful to charge interest for both the day of discount and the day of maturity, stating that:

"The mode of computing interest in a case like the present is: Exclude the day on which the note is discounted and on which it ought for this purpose, if not every other, be considered as delivered. It being discounted on the 16th, any time on the 17th, without regarding the fractions of that day, there would be one day's interest; and so on through the whole 64 days. By this mode of computation, the bank took as interest upon $2,000 for 64 days, 29 cents too much; that is almost, but not quite, one day's interest upon the sum of the note.

". . . . The taking of the 29 cents, as above mentioned, is the taking of more than the 6 per cent. allowed by the statute."

In the case decided in the Virginia Court of Appeals in 1834 (*Crump v. Nicholas* 5 Leigh 251) the opposite opinion was expressed. The circumstances were as follows:

The Farmers' Bank of Virginia discounted a note for $6,000, payable on its face 60 days after date, it being understood that

the loan would be renewed indefinitely till it should suit the interest or convenience of either the bank or the borrower to terminate the arrangement. In point of fact the loan was continued on renewal notes from 21st April, 1825, to 4th May, 1826. In discounting the first note, the bank deducted interest for 64 days, *i. e.*, counting from the day of date to the last day of grace, both inclusive, and in discounting the second note, made on the last day of grace of the first, likewise deducted interest for 64 days, counting from the day of date of the second and last day of grace of the first, to the last day of grace of the second note, both inclusive; and so on upon each renewal note successively to the end of the transaction. Thus the bank received double interest for every 64th day. This was in conformity with the known usage of the Farmers' Bank and of all the banks of Virginia.

It was held that the transaction was in nowise usurious. The unanimous opinion of all the judges was that the charge of interest for both the first and last days on the first note was lawful, as a borrower, when making a loan, may receive and have the use of the money borrowed early in the morning of the first day, and is not bound to pay until the last moment of the bank day when due, and hence, the law knowing no fraction of a day, has the use of the money both days, but a dissenting opinion was filed as to the legality of charging double interest for the days on which the renewal notes were given. Four judges held that as there was no binding agreement to renew the loan, each discount was a separate and distinct transaction, and the same treatment of the renewals as of original note was permissible. The dissenting judge raised no question as to the propriety of charging double interest for the renewal date *per se*, but claimed that on the day of each renewal the previous intention or expectation to renew was carried into effect and became an agreement between the parties on that date and the discount and the appropriation and application of the proceeds of the new note to the payment of the maturing note, by consent of both parties, were evidence of the agreement and con-

sequently all the notes excepting the first were tainted with usury.

"When judges disagree who shall decide?" Before attempting to say what rule would be most equitable to follow—since from the foregoing decisions it seems to depend upon what part of the country one is in as to what rule would be lawful—it would be well to consider the question from another side. Banking institutions, which are usually the lenders who charge interest for both first and last days, do not allow interest on deposits on the same basis, hence why pursue an opposite course with regard to interest charged on loans? As the officer of a large trust company expressed it: "We allow interest on the basis which requires us to pay out the least money," and had he gone on to refer to the basis of charging interest on loans he would doubtless have stated quite as frankly that 'we charge interest on the basis which brings us in the most money." Such a course, however, is certainly not equitable.

On the whole the fairest rule would seem to be that laid down in the paragraphs quoted in the earlier part of this chapter, viz., to exclude either the first or last day from the period of time for which a calculation is being made. In Kirkbride and Sterrett's "The Modern Trust Company" (page 84), the rule is stated thus: "In computing interest on loans, the actual number of days is taken. If the day on which the loan was made is included, the day of payment is not counted."

Because of the lack of uniformity among financial institutions with regard to interest and discount on loans this has been made more particularly the subject of review in the foregoing paragraphs, but the principle is the same in any business or in any transaction involving interest. Interest on book accounts would naturally be calculated on the same principles as negotiable instruments. In commercial houses the custom is to include either the first or last day, not both, in making interest calculations.

Among stock brokers there is also some lack of uniformity in charging interest on customer's accounts. The purchases of one day are settled for the following day, which is when the customer's account is debited, and by some brokers both this day and the last day of the month are included in calculating the interest charge for the month in which the purchase is made. For the reasons already stated, however, the charge should only take into account one or the other of the two days in question, though it should be said in favor of the broker that as long as he is compelled to pay interest on his loans payable on the basis of including both days in the calculation, he would seem to be entitled to charge his customers interest on a like basis.

A practice on the part of some trust companies of crediting interest on deposits only from the day following the deposit is injecting the factor of exchange into the question; the reason for the practice is to allow the trust company one day in which to make collection of the checks which form the bulk of most deposits. In the case of large deposits consisting of items drawn on distant points the credit of interest might, of course, be suspended for a longer period than one day.

The second question relating to the factor of time is, as has already been mentioned, the unit period on which the calculation is based. Interest rates are usually stated on an annual basis, *i. e.*, they are expressed as a percentage of the principal which is to be added thereto for the use thereof for one year. Even when the rate is not stated as so much "per annum" it is, unless expressly stated otherwise, usually so understood.

Payments of interest made periodically in pursuance of an agreement do not as a rule raise any question concerning their calculation. If monthly, quarterly or semi-annual payments they are simply one-twelfth, one-fourth or one-half of the interest for a full year.

In the case of interest for fractional or odd periods of time varying methods of calculation are again encountered. Theo-

retically the correct method would be to ascertain the number of days and take this number of 365th of a full year's interest. Some banking institutions use this method, though by far the greater number base their calculations on a year of 360 days. The latter method is the most convenient when interest tables are not used, but when tables are used one method is just as simple as the other.

In 1824 the Supreme Court of New York ruled that the taking of interest on the basis of 360 days to the year was usurious. (*N. Y. Firemen Ins. Co. v. Ely* 2 Cowen 705). In the case of *Bank of Burlington v. Durkee,* to which reference has already been made (*vide* page 344), the Supreme Court of Vermont stated that it was not prepared to go to the same length to which the New York Supreme Court had gone, and said:

"If a bank commences and carries on its operations in a way pursued by all the banks in the country, and the way that has been pursued by them for 30 years, and even from the first establishment of banks in this country, and uses the same tables for casting interest; or, to speak more properly, takes the interest from those tables already cast, for any sum and any term, those same being printed tables and kept for the accommodation of banks and business men; and during all this time the mode of casting and taking interest has been acquiesced in as correct and no resistance made to it in any of the numerous actions in which the defence might be made, if good in any case—under all these circumstances, it cannot be presumed that the bank acted with any intention to oppose or violate the statute. In such a case the bank would have reason to believe that the statutes of usury had received a construction from the bench that sanctioned this mode of casting interest, or at least that it received the universal approbation of mankind. The going in a path so well understood, so long in use and in such general use, precludes all presumption of any intention to evade the statute or do any wrong whatever."

The court accordingly held that while the bank might have taken usury the transaction was made in good faith, in pursuance of long established usage and with no intent to disobey the law, and the court declined to inflict the extreme penalty of usury, but merely stated that the bank's claim ought to be reduced by 29 cents.

In a case decided in the Virginia Court of Appeals in 1837 (*State Bank of North Carolina v. Cowan, etc.* 8 Leigh 238) the claim was made that discounts of notes at 6 per cent., based on 360 days to the year instead of 365 were usurious. The court, however, held otherwise.

Many states have by statute legalized this banking usage, in others it is permitted or obtains merely by force of custom. In the revision of the statutes of New York in 1892 the statute legalizing the 360-day basis of interest was dropped and at present time this method of calculating interest, when the maximum rate is charged, is technically illegal in that state.

Under an act passed at the 1909 session of the Massachusetts legislature and approved on March 6, 1909, interest on all loans of money and on all bonds and notes purchased or held by the Commonwealth will hereafter be computed on the basis of 365 days to the year instead of 360 days. The law is known as Chapter 148 of the Acts of 1909 and reads as follows:

An Act Relative to the Computation of Interest on Bonds and Notes in Dealings with the Commonwealth.

Be it enacted, &c., as follows:

Section 1. On all loans of money made to or by the Commonwealth and on all bonds and notes purchased or held by the Commonwealth, interest shall be computed on the basis of three hundred and sixty-five days to the year and not on the basis of three hundred and sixty days to the year.

In calculating interest for a part of the period for which it may regularly be paid, say quarterly or semi-annually, as on

bonds or mortgages, it is probably more general to state the time in months and days than entirely in days. In such a case the number of full months from the date to the same numbered day next preceding the final date should first be determined and then the odd days to the final date.

The months, irrespective of whether they have 30 or 31 days, would be treated as so many twelfths of a year, but as to the odd days there is again a variation in treatment, sometimes being taken as so many 30th of a month (equivalent to a 360-day basis), and sometimes being figured as so many 28th, 30th or 31sts, according to the month in which they occur. With the latter method difficulty arises if part of the odd days are in a month having 30 days and part in one having 31 days, *e. g.,* from 23rd April to 15th May would be 22 days, but shall they be considered 30th or 31sts of a month? Either way of treating them would be to a certain extent arbitrary. Still another method of dealing with the odd days would be to consider them as 365th of a year. Either the first or the last method would seem to be preferable, the first (treating them as 30ths) having the merit of consistency, as it brings the treatment of the full months and the odd days more nearly on the same basis, though the last is doubtless more strictly in accord with the law in those states which have no statute legalizing the 360-day basis.

The auditor who has occasion to verify interest calculations will naturally first acquaint himself with any special conditions or circumstances which may obtain. *E. g.,* savings banks frequently have rules concerning the interest to be allowed on deposits which provide for certain concessions or the reverse. Deposits made on any day between the first and fifth may be permitted to draw interest from the first of the month, while deposits after the fifth may not draw interest until the following month. In some cities where the savings banks and trust companies allow a rate of interest on time deposits which is higher than obtains in many other cities, they have rules concerning the calculation of interest which result in reducing

materially the average rate actually paid on deposits. These rules in one large city are:

> That deposits from the 2d to the 15th of the month draw interest only from the 15 of the month; deposits from the 16th to the 1st of the following month draw interest only from the latter date.
>
> Withdrawals during any semi-annual interest period lose all interest accrued thereon since the last interest date.

The first rule is not any more severe than the rules usually obtaining, as it is quite a general custom to allow interest on savings deposits only by full calendar months. The latter rule, however, is the one which accomplishes the greatest reduction in the rate of interest actually paid. A large sum of money withdrawn after having been on deposit for, say five months since the last interest date, receives no interest whatever for that period.

It may be of interest to note the rules for calculating interest which obtain in the Treasury Department of the Government. The following is the substance of information furnished by the Government Actuary:

Only one of the two days of date and due date of an obligation is taken into account in stating the time for which interest is to be calculated.

When interest is payable semi-annually or quarterly, half or one-quarter of a full year's interest is apportioned to each period.

In calculating interest for a fractional period, the time is the true fraction of that period. For an annual rate, the time is the exact number of days for which the interest runs divided by the number of days in the year, 365 or 366; for a semi-annual or quarterly period, it is the number of days for which interest runs divided by the number of days in that particular half year or quarter year.

Unless the unit period is a month the month does not enter into interest computations; only days and the full unit period being considered.

A few words on discount and usury, which are closely related to, or rather form a part of, the general subject of inter-

est, are in order. Any one who gives the matter any consideration can readily see that to collect interest in advance or to "discount," results in a rate of interest, when calculated on the amount actually received by the borrower, higher than the nominal rate. When the nominal rate of the discount is the highest rate of interest permitted by law—and a large majority of the states have fixed the maximum rate which may be charged—technically it becomes a usurious transaction. The following extracts from a review of the legal status of the practice indicate that the courts generally have held that unless used to excess it will be permitted (29 L. R. A. 761-8).

"In general, it must be regarded as well established that, at least on short-time paper, interest may be taken by way of discount in advance, and at the highest rate allowed by law, although this does in reality make the interest paid, if computed on the amount actually received for use by the borrower, exceed the legal rate by the amount of the interest upon the interest for the time of the debt. . . . .

"The right to take interest in advance is expressly given to national banks by U. S. Rev. Stat., §5197, which fixes the rate at 7 per cent. in cases where no rate is fixed by the laws of the state, territory or district where the bank is located, but providing that such banks shall not take greater interest than the local laws permit; except where such laws fix a different rate for the state banks of issue, and then such rate is allowed to the national banks.

(There have been decisions in which discount or interest taken in advance for a period of one year or even longer have been held to be not usurious.)

"A note for $8,880, payable one year from date, given in renewal of a note for $8,000, was held usurious under a statute authorizing 10 per cent. interest, although interest could be lawfully taken in advance (*First National Bank v. Davis*, 108 Ill., 633). Two judges dissented from this decision on the ground that the amount of the note was no more than might have been realized from lawful interest had the interest for one year been paid in advance. . . . .

"Nearly all cases have upheld payments of interest in advance when interest was paid periodically."

The laws of New York expressly provide that a bank or banker may deduct interest in advance, as will be noted in the following:

Section 74 of the Banking Law, as contained in the Consolidated Laws of the State of New York, enacted in 1909 (being Chap. 10 of the Laws of 1909 and Chap. 2 of the Consolidated Laws of that year in Article III thereof) is as follows:

"RATE OF INTEREST. Every bank and private and individual banker doing business in this state may take, receive, reserve and charge on every loan and discount made, or upon any note, bill of exchange or other evidence of debt, interest at the rate of six per centum per annum; and such interest may be taken in advance, reckoning the days for which the note, bill or evidence of debt has to run.

"The knowingly taking, receiving, reserving or charging a greater rate of interest shall be held and adjudged a forfeiture of the entire interest which the note, bill of exchange or other evidence of debt carries with it, or which has been agreed to be paid thereon. If a greater rate of interest has been paid, the person paying the same, or his legal representatives, may recover twice the amount of the interest thus paid from the bank or private or individual banker taking or receiving the same, if such action is brought within two years from the time the excess of interest is taken. The purchase, discount or sale of a bona fide bill of exchange, note or other evidence of debt payable at another place than the place of such purchase, discount or sale at not more than the current rate of exchange for sight draft, or a reasonable charge for the collection of the same, in addition to the interest, shall not be considered as taking or receiving a greater rate of interest than six per centum per annum.

The true intent and meaning of this section is to place and continue banks and private and individual bankers on an equality in the particulars herein referred to, with the national banks organized under the Act of Congress entitled, 'An act to provide a national currency secured by pledges of United States bonds, and to provide for the circulation and redemption,

thereof,' approved June third, eighteen hundred and sixty-four."

In conclusion, the following rules on points concerning which there is a variation in practice, might be formulated as being the most accurate, and most equitable to both the payor and payee of interest.

1. In stating the time between two dates, include only one of the two days, not both.

2. For interest payable at regular intervals, as semi-annually, quarterly or monthly, such periods should be considered as one-half, one-quarter or one-twelfth, respectively, of the year.

3. For a fraction of any of the foregoing periods the time should be stated in months and days, each month being considered one-twelfth of a year, and the odd days as 30ths of a month.

4. When interest is calculated for the actual number of days in a period, it should be on the basis of 365 days to the year.

5. The foregoing rule may be modified where a definite and well understood custom exists of charging and paying on the basis of 360 days to the year, but the custom should be known to both parties.

APPENDIX A.

Summary of the Rules laid down by the Courts with respect to, and Reports of Cases dealing with, the Rights and Liabilities of Auditors.

So far as we are aware, no reported case in America has yet dealt with the liability of professional auditors. We are. therefore, compelled to resort to the English decisions, from which we deduce the following legal rules:—

It will be observed that the courts have laid down rules of liability which are by no means onerous; and indeed it would seem that the practice which we have advocated in the preceding pages of this book is considerably stricter than the courts require. However, it is always well to be on the safe side, and an auditor can have the satisfaction of knowing that if he follows the practice which we have heretofore laid down, he will be amply on the safe side of the law.

Remembering then that the following are simple rules of legal liability laid down by the courts, and not rules of practice which the authors would in all cases advocate, we summarize the English decisions as follows:

1. An auditor must do more than ascertain the arithmetical accuracy of the balances. He must see that the books give a true and accurate representation of his clients' financial affairs.

2. In doing this, the auditor is not an absolute insurer of the accuracy or truthfulness of the books. He is bound only to use reasonable care, the care of an ordinarily skilful auditor under the particular circumstances.

3. What is reasonable care in any given case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry may be sufficient. It is legally sufficient for the auditor to select a few cases haphazard, see that they are right, and assume that others like them are correct also; check the cash, examine vouchers for payments, see that the bills and securities entered in the books are correct, and take reasonable care to ascertain their value. He is not bound to take stock; he should, however, satisfy himself as to its accuracy so far as he can. As to the other assets and liabilities he must use reasonable diligence in verifying them before certifying to the correctness of the balance sheet.

4. Until the contrary is suggested by circumstances of obvious suspicion appearing on the books themselves, the auditor is justified in assuming that the clients' clerks, bookkeepers, officers *et al.* are honest.

5. Unless some suspicious circumstance exists, the auditor is not legally bound to communicate with third parties (customers or creditors) to see if their accounts are accurately stated in the books. Unless he has been elected by the stockholders, he probably has no right to report to them directly at all.

6. An auditor's report must plainly point to the client any unsatisfactory features of the account. The auditor does not discharge this duty by simply giving the client so much information as is calculated to induce the client to ask for more. The auditor must convey information, not merely arouse inquiry.

The following extracts from the cases are instructive. As heretofore mentioned, these cases are reported in greater detail in the Seventh English Edition of this work, and reference thereto should be had if additional information is desired.

Leeds Estate Building & Investment Society, Lim., v. Shephard, L. R. 36 Ch. Div. 787 (August 9, 1887.)

Dividends had been paid out of capital and the auditor had passed the account.

Held: That it is the auditor's duty not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs.

In examining the balance sheets the auditor was not furnished with a copy of the articles of incorporation, and he did not comply with their provisions. Held: That it was no excuse that the auditor had not seen the articles when he knew of their existence.

In Re London & General Bank, 1895, 2 Ch. Div. 673.

An auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention to the grounds of his dissatisfaction in his certificate.

The court discusses the matter at length as follows:—

"It is not part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any

trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the auditor has to frame a balance sheet showing that position according to the books, and to certify that the balance sheet presented is correct in that sense. *But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company.* This is quite in accordance with the decision of Mr. Justice Stirling in *The Leeds' Estate Company v. Shephard,* in 36 Chancery Division, page 802. An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and

skill even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

"Mr. Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance sheet. He did not content himself with making his balance sheet from the books without troubling himself about the truth of what they showed. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were correct, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty.

"The balance sheet and certificate of February, 1892, that is, for the year 1891, was accompanied by a report to the directors of the bank. Taking the balance sheet, the certificate, and report together, Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance.

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would by its consequent publicity be very injurious to their interests, and in such a case I am not prepared to say that an auditor would fail to discharge his duty, if instead of publishing his report in such a way as to ensure

publicity, he made a confidential report to the shareholders, and invited their attention to it, and told them where they could see it. The auditor is to make a report to the shareholders, but the mode of doing so, and the form of the report, are not prescribed. If, therefore, Mr. Theobald had laid before the shareholders the balance sheet and the profit and loss account accompanied by a certificate in the form in which he had prepared it, he would, perhaps, have done enough, under the peculiar circumstances of the case. I feel, however, the great danger of acting on such a principle, and in order not to be misunderstood, I will add that an auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held judicially, to have failed to discharge his duty.

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words 'The value of the assets as shown on the Balance Sheet is dependent upon realization.' The most important asset on that balance sheet is put down as 'Loans to customers and other securities, £346,975,' and on those a full and detailed report was made to the directors, showing the very unsatisfactory state of these loans and securities, and it is impossible to read the oral evidence, the report of Mr. Balfour and Mr. Brock, dated the 22d of December, 1891, and the report of the auditor to the directors of the 3d of February, 1892, without coming to the conclusion that the entry of that large sum as a good asset without explanation was unjustifiable. It is a mere truism to say that the value of loans and securities depends upon their realization. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, the duty of an auditor is

to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it.

"But Mr. Theobald relies on the fact that he was induced to omit from his certificate all reference to the report which he made to the directors, because Mr. Balfour, the chairman, promised to mention such report in his speech to the shareholders, and he did so. But although Mr. Balfour twice alluded to the report, he did so in such a way as to avoid attracting attention to it. The second time he mentioned it was after a dividend had been declared, and when a motion to re-appoint the auditors was before the meeting. The truth is that not a word was said to convey to the shareholders the substance of the information contained in the report, or to induce them to ask any question about it. The balance sheet and the profit and loss account were true and correct in this sense, that they were in accordance with the books. But they were, nevertheless, entirely misleading, and misrepresented the real position of the company. Under these circumstances, I am compelled to hold that Mr. Theobald failed to discharge his duty to the shareholders with respect to the balance sheet and certificate of February, 1892. Possibly he did not realize the extent of his duty to the shareholders as distinguished from the directors, and he, unfortunately, consented to leave the chairman to explain the true state of the company to the shareholders instead of doing so himself. The fact, however, remains, and cannot be got over, that the balance sheet and certificate of February, 1892, did not show the true position of the company at the end of 1891, and that this was owing to the omission by the auditor to lay before the shareholders material information which he had obtained in the course of his employment as auditor of the company, and to which he called the attention of the directors.

"The real truth is that the assets of the bank were put down in the balance sheet at far too high a figure, and this entry, though not misleading if explained (as it was to the directors), was seriously misleading in the absence of explanation."

The *London & General Bank* case just cited is a fair example of facts which charge the auditor with liability.

In Re Kingston Cotton Mill Co., 2 Ch. Div. 279, decided in the Court of Appeal, May 19, 1896.

The following extract taken from this case shows facts which do not charge the auditor with liability.

"I come now to the real question in this controversy, and that is, whether the appellants have been guilty of any breach of duty to the company. To decide this question it is necessary to consider (1) What their duty was; (2) How they performed it, and in what respects (if any) they failed to perform it. . . . I protest against the notion that an auditor is bound to be suspicious, as distinguished from being reasonably careful. To substitute the one expression for the other may easily lead to serious error. I pass now to consider the complaint made against the auditors in this particular case. The complaint is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not honestly believe to be true. It is said, however, that they were culpably careless. The circumstances are as follows: For several years frauds were committed by the manager, who, in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills. He did this at the ends of the years 1890, 1891, 1892, and 1893. There was no book or account (except the Stock Journal, to which I will refer presently) showing the quantity or value of the cotton or yarn in

the mill at any one time. It would not be easy to keep such a book. Nor is it wanted for ordinary purposes. There is considerable waste (twenty or twenty-five per cent. on the average) in the manufacture of yarn from cotton, and the market prices of both cotton and yarn are subject to great fluctuations. The balance sheets of each year contained on the assets side entries of the values of the stock-in-trade at the end of the year, and those entries were stated to be 'as per manager's certificate.' There were also in the balance sheets entries on the opposite side of the values of the stock-in-trade at the beginning of the year. The quantities did not appear in either case. The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance sheet, and they took the values of the stock-in-trade at the end of the year from the Stock Journal. The book contained a series of accounts under various heads purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts, showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors, and was inserted as an asset in the balance sheet, but 'as per manager's certificate.' The summary always corresponded with the accounts summarized, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarized. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet.

In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by every one who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason. The Stock Journal showed the quantities—that is, the weight in pounds—of the cotton and yarn at the end of each year. Other books showed the quantities of cotton bought during the year and the quantities of yarn sold during the year. If these books had been compared by the auditors they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shown in the Stock Journal, and so much less that the value of the cotton and yarn entered in the Stock Journal could not be right, or, at all events, was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But, although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think that any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of

a cashier who has to account for the cash which he receives, and whose own account of his receipts and payments could not be reasonably taken by an auditor without further inquiry.

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable care, skill and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful. His Lordship then referred to the circumstances which led to the auditors being deceived, and came to the conclusion that they were not wanting in skill, care or caution, in accepting the figures of the manager, and he concluded as follows:—The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than *In re The London and General Bank*. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance sheet certified by the auditors and presented to the shareholders. This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company, and are unde-

tected for years by the directors. So to hold would make the position of an auditor intolerable."

Wilde and others against Cape and Dalgleish, decided by the Queen's Bench Division, May 27, 1897 (reported unofficially in the London Times of May 28, 1897; also in the "Accountant" (Eng.), June 5, 1897; also in Dicksee's "Auditing," 7th English Ed., at p. 679).

Here the court held the whole question to be simply one of fact, to wit: Did the accountant contract and agree to act as a simple accountant, and merely to see that the books are brought to a correct balance, taking the entries and balance in the books as correct; or on the other hand did the accountant contract and agree to act as an auditor and make a cash audit, and check receipts and payments, and examine the cash and bank book and be responsible for the accuracy of the cash transactions?

Irish Woolen Company, Lim., against Tyson and others, decided by the Irish Court of Appeal, January 20, 1900 (unofficially reported in the "Accountant" (Eng.), February 3, 1900; also in Acct. L. R. 1900, p. 13; also in Dicksee's Auditing, 7th Eng. Ed., p. 702.)

In this case it was held that when the accounts of a company have been falsified and dividends improperly paid out of capital in consequence, the auditor is liable if the falsifications might have been discovered by the exercise of reasonable care and skill from an inspection of the books themselves.

"An accountant with a large business is not supposed to do everything himself. The auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy. I do not think there is anything to be gained by considering in the abstract the duties of an auditor of a joint-stock company. He is entitled to see the company's books and the materials for their books, and also to ask for explana-

tions. But he is not called on to seek for knowledge outside the company, or to communicate with customers or creditors. He is not an insurer against fraud or error; and if fraud is alleged it must be shown with precision the acts of negligence for which he is said to be responsible. Nine balance sheets were prepared, and the figures on some represent the aggregate amount of many items, but I propose to deal only with matters that have been referred to during the hearing. There are three sets of figures with which I will deal:— (1) Stock-in-trade; (2) sundry debtors; (3) sundry creditors on the liability side of the balance sheet. Taking these in order . . . There was certainly no duty cast on the auditor to take stock. What he did was to have the calculations checked in his office, and this was done with proper care. Mr. Kevans said he was particularly careful as to the deduction for discount, and, as far as I could gather, the universal rate of ten per cent. seems reasonable. Moreover, an auditor has nothing to do with the terms upon which the company, or a trader, buys or sells. . . . As to the provision for the 'bad debts,' if there is any one thing upon which an auditor is dependent upon the officers it is the writing off, or the making of a prospective allowance for, bad debts. He has no personal knowledge of the customers, and Mr. Kevans seems to have taken particular attention in reference to this. (See questions 2,125 to 2,127 in the evidence.) He said 'he had some special knowledge on the subject, that he saw all ascertained bad debts duly written off, and that there was a fund amounting to £500 as a provision therefor.' For the foregoing reasons there is no ground for alleging negligence against Mr. Kevans on the 'assets side' of the balance sheet. . . . Now, dealing with 'sundry creditors'; here, evidently, there is a fraud, and a curious thing is that no one seemed to have derived any benefit from the fraud. Dealing with the invoices, the learned judge detailed the practice in connection with the statements of accounts being laid before the meeting, and said, the ledger was used for the purchases made and for the payments on ac-

count thereof. If, then, all this were rightly done it would be easy for the auditor to ascertain the amounts due to the creditors, but, unfortunately, the books were not correctly kept. The creditors' accounts in the ledger did not show all the goods purchased up to the time of the audit, nor could the auditor discover the omissions on account of many of the invoices being either 'suppressed' or not put into the book until a later date—a process described as 'carrying over.' There is some doubt as to whether the deficiency arose from the suppression or the carrying over, but my impression is that the whole of it comes within the last-mentioned class, for at the end of 1894, we find they amounted to £4,095. Mr. Peter White is now dead, and he should not be condemned unheard, but it is difficult to believe that this system was not within his own knowledge. As chief promoter he was no doubt anxious to see that the company was successful; Crawford, who was the secretary, appears to have continued the process. It seems strange that a system of fraud so long continued, and for so extensive a period, was never detected by the auditor. Once or twice he noticed something, and the explanation that was given was 'that the goods were not taken into stock.' The question is, Was it negligent not to have seen this? There is no doubt that both the suppression and carrying over of invoices would have been detected if the auditor had called for the creditors' statements of accounts upon which payment was ordered, and compared them with the ledger. I should have thought this was part of the auditor's duty for many reasons; but all the accountants examined, except Mr. Southworth, stated that this course is never taken unless there is something to arouse suspicion. Mr. Pixley, the eminent London accountant, says it could not well be done except in the case of a very small concern. In the face of such evidence, I should not leave myself at liberty to hold that Mr. Kevans' assistants were guilty of negligence in not looking at these statements of account if they were engaged in an ordinary audit. Little time is allowed for doing so; but in this case there was this system of monthly checking. From the time that Crawford was ac-

countant in 1890 the accounts of the company were completely in his hands. Now, White for the two years following may have given general directions, but he was often away in America for months at a time, and it is clear that the monthly audit was instituted for the purpose of seeing that he (Crawford) would do his work regularly and honestly. I am unable to conceive how, if there was nothing wrong about this monthly checking, it did not lead at an early period to the detection of the frauds in this ledger. Mr. Kevans ought to have found out, by the accounts, the payments that were made—and no better means could be adopted than that of a comparison with the statements of accounts. It ought to have been done in some way, and, if it had, detection would have been certain. I do not base my decision on this alone; apart altogether from the statements of account and the monthly check, I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill, and who was not a mere machine. The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates, it would be at once apparent that they were not entered in at the proper time. If they were posted under false dates, why was this not detected when the ledger accounts were checked with the invoices? And when no invoices came into the books, it is admitted that this ought to have excited suspicion. For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and suppression of invoices would have been discovered, and the auditor is liable for any damage the company may have sustained from the understatement of liabilities in the balance sheet due to this cause since January 4, 1892. I consider that not only are Mr. Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out.

. . . . . .

"As regards the measure of the duty of a gentleman employed, as Mr. Kevans was in this case, the result is the same, as it occurs to me, in all cases in which professional skill is

employed, except one, the peculiar instance of a barrister. The measure of duty is the bringing of reasonable care and skill to the performance of the business directed to be done, having regard, first to the contract of employment, then to the character of the business itself, to the remuneration of the defendant, and to all the other circumstances of the case. In strict rule, however, the measure of the duty is to be ascertained by applying to all the circumstances of the case the best consideration, so as to ascertain what ought to have been done under the circumstances. . . . I think the fairest way to deal with Mr. Kevans in this case is to treat him as being charged with having failed to find just cause of suspicion on the face of these books, which, if found, would have imposed on him the duty of pursuing his suspicion until he found whether it was or was not well founded. . . . The English cases have established that the auditor is entitled, in the absence of the elements of suspicion, to assume that the books are honestly kept, and that, therefore, unless on the face of a presumably honest book something appears to excite his suspicion, he is not guilty of negligence, whatever other people might be in their departments, if he does not discover that something was wrong." . . .

(The suspicious circumstance in this case is then referred to by the Court as follows:)

"I cannot conceive any more clear or glaring grounds of suspicion than to discover in the account of a single customer items amounting to £600 having got into the books after the trial balance is struck under dates going back two months prior to the period of the ascertaining of the trial balance. . . . . It appears to me that the moment I come to the conclusion that that was on the face of it a suspicious mode of dealing with Hill & Son's figures, I am bound to show how it would be corrected. . . . That it would then have been necessary to call for the creditors' statements of account, and at that moment they would have disclosed on the face of them not merely those postdated items, but the suppressed invoices

also; and at the instant that this discovery was made there is an absolute conviction of something wrong forced upon the mind of the auditor. It, therefore, occurs to me that, upon these two branches, all that is required, both to show the negligence, to arouse suspicion, and to supply the means of putting a stop to the frauds, is to be found on the face of the books, and for all I have said I have no foundation except what is upon the face of that book (Creditors' Ledger)."

The converse of the *Irish Woollen Co.* case is found in

Short and Compton v. Brackett, Colchester County Court, May 6, 1904 (unofficially reported in the "Accountant" (Eng.), May 14, 1904; also in Acct. L. R. 1904, p. 85; also in Dicksee's "Auditing," 7th Eng. Ed., p. 813).

There the clerk made out a wage bill each week for a larger amount than was due to the men and kept the balance. An auditor examined the books on behalf of an incoming partner. At the time of the examination there was no suspicion against the clerk, and there was nothing on the face of the books to arouse suspicion.

Judge Tindal Atkinson held that, having regard to the object for which they were employed, the plaintiffs were entitled to assume that the figures appearing in the defendant's books as paid for wages were correct, and in view of the fact that at the time there was no suspicion of any defalcation by the defendant's clerk alluded to, he thought there was no negligence on their part. Therefore judgment would be for plaintiffs on the claim with costs.

It is important to bear in mind here that no audit in the proper sense of the term was ever performed, in that the investigating accountant (being presumably employed by the incoming partner) owed no duties to the existing partners. As pointed out in Chapter XI., in investigations as to profits, the object is to make sure that the profits have not been exaggerated, rather than to see whether they have not been understated and the difference misappropriated by employees.

London Oil Storage Co., Lim., against Seear, Hasluck & Co., King's Bench Division, June 1, 1904; unofficially reported in the London Times, June 2, 1904; also in the "Accountant" (Eng.), July 2, 1904; also in Acct. L. R. XXXI., p. 1; also in Dicksee's "Auditing," 7th Eng. Ed., p. 815).

In this case the auditor took no steps to verify the existence of petty cash as stated in the balance sheet. The balance sheet showed £796 petty cash, whereas only £30 was actually in the cash box, the bookkeeper having embezzled the difference. The court left it for the jury to find as matter of fact, whether or not the auditor's failure to verify this balance was negligent under the circumstances. The court charged the jury in part as follows:—

"The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties, or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage. I will not adopt any fanciful expression which may be quoted from any particular judgment, but he has got to bring to bear upon those duties reasonable and watchful care, he has got to discharge those duties remembering that the company look to him to protect their interests. He is not, however, supposed to be a man constantly going about suspecting other people of doing wrong, and that is the only respect in which, I think, Mr. Bankes in his most able speech pressed the matter a little too high. While Mr. Hasluck has by the exercise of due and reasonable care to see that all the officials of the company are doing their duty properly in so far as the accounts are concerned, he is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people; and there comes in the most important consideration from one point of view—perhaps more important than the other, though I do not think of such substantial weight in the matter—if circumstances of suspicion arise, it is the duty of the auditor, in so far as those circumstances

relate to the financial position of the company, to probe them to the bottom."

It will be seen that this rather follows the *obiter dictum* in the *Kingston Cotton Mill case,* p. 363, as to the obvious conflict between the interest and the duty of a cashier. The point is, of course, made all the clearer by the circumstance that so large a balance of *Petty* Cash would be unprecedented as to naturally call for inquiry if the least care were being taken. It should be noted that in this case the damages awarded were not at all in the nature of compensation for the loss sustained by the plaintiffs, but merely represent a nominal sum to mark the fact that the audit had not been performed with all due care.

Herbert Alfred Burleigh against Ingram Clark, Lim., Chancery Division, April 2, 1901 (unofficially reported in the "Accountant" (Eng.), April 27, 1901; also in Acct. L. R. 1901, p. 65; also in Dicksee's "Auditing," 7th Eng. Ed., p. 765.)

This case decided that an accountant has a lien on such books as he has actually worked upon for the work done upon those books only. The judges also said by way of dictum that an *auditor* had no such lien. The distinction between accountant and auditor, as drawn in this case, is that the accountant does work *on* the books, and the auditor does work *in respect of* the books. The accountant actually writes in the books themselves, while the auditor merely looks at the books, and does his work on other pieces of paper.

Martin v. Isitt, decided before Lord Chief Justice Russell, in the Queen's Bench Division, March 3 and 4, 1898, (unofficially reported in Acct. L. R. 1898 p. 41; also in Dicksee's "Auditing," 7th Eng. Ed. p: 680).

Considerable interest attaches to the foregoing case on account of the discussion therein as to the duties of an auditor to attend promptly to periodical audits.

This was an action brought by Messrs. James Martin & Sons, milk and grain merchants, against Messrs. Isitt & Co., Chartered Accountants, for negligence in not checking the cash book and the bank pass book, whereby a clerk was enabled undiscovered to embezzle £612 19s. 2d., the property of the plaintiffs. The defendants alleged that they were unable to properly proceed with their agreed work, owing to the neglect of the plaintiffs to give proper facilities, and in particular they complained that the books were not properly posted up and were full of errors, of which the defendants were unable to get the necessary explanations.

It appeared that in 1887 Mr. Eldrid, now a member of the defendants' firm, agreed with plaintiffs to do certain work which was not material to the present action, and also undertook the "monthly checking of all your books" for an inclusive fee of thirty guineas, afterwards increased to sixty guineas. It was not the defendants' duty to audit, but merely to "check" the books. To enable this to be done clerks were sent down to the plaintiffs' head office at Brockley, and they spent there a very considerable number of hours doing the requisite work. The books were written up and posted by the plaintiffs themselves; with this the defendants had nothing to do. It further appeared that a man named May, in charge of a branch of the plaintiffs' business, received money, and in a weekly statement sent to the plaintiffs credited himself with payments into a bank, which payments should in ordinary course appear in the London and County Bank pass book of the plaintiffs. In fact, from the last week of November, 1896, until the end of March, 1897, he habitually embezzled the money. The plaintiffs would enter in their cash book the amount alleged by May to have been paid into the bank; the pass book, of course, would not agree with cash book, and the plaintiffs complained that this was not discovered until the first days of April, 1897. It was admitted that the discovery was made by, and was due to the work of the defendants; but it was then alleged against the defendants that the

discovery should have been made earlier. The reply of the defendants to this was that the state of the books was such, and the queried items—the explanations of which were constantly delayed—were so numerous, that they were unable to proceed fast enough to keep pace; and that, in December, 1896, they were still engaged in dealing with the entries relating to the summer months of 1896. Further, they said that they were requested by the plaintiffs not to proceed with the work in January, and that the month of February was wasted away to the default of the plaintiffs. The senior member of the plaintiffs' firm was called, and gave evidence supporting his own and negativing the defendants' case, but his cross-examination was not concluded when the court rose for the day.

Before resuming the hearing next morning, a consultation took place between counsel, and as a result, Mr. Carson stated that he understood that it would not now be contended that the defendants had been negligent or unskilful in the way in which they had done their work, but that the plaintiffs would rest their case on a breach of one term of the contract—viz., the agreement to attend monthly. That being so, and recognizing that the plaintiffs had suffered a loss, the defendants were quite willing to share that loss to a certain extent, and consequently terms had been arranged.

The Lord Chief Justice said that as he understood the case as placed before him, no allegation of negligence or unskilfulness was now made, but that it was urged that the defendants should have attended somewhat earlier than they actually did; that was a question to be tried, but he thought the action of the parties in arranging the matter to be very proper.

Smith against Sheard, Liverpool Assizes, May 11, 1906 (reported in the "Accountant," L. R. 1906, p. 65; also in Dicksee's "Auditing," 7th Eng. Ed., p. 833.)

Claim was made by the plaintiff that, in consequence of the inefficient auditing of the books by the defendant, the em-

bezzlement of some £700 by the plaintiff's cashier had not been detected. The defense was that no agreement had ever been made for a complete audit, but that the only work contemplated was the stating of the accounts between partners, and later, after one of the partners had withdrawn, on behalf of creditors, the books being accepted as they stood, and only such auditing done as was absolutely necessary to the preparation of statements.

The case was tried before a special jury, and the charge of the trial judge seemed to be very favorable to the defendant. The jury, however, found for the plaintiff, thus assenting to the allegation that there had been an agreement for a complete audit. This case shows the extreme importance of a distinct understanding, not only verbal, but written, when a partial audit is to be made or statements to be prepared without any audit whatever.

Newton against Birmingham Small Arms Company, Lim., Chancery Division, June 27, 1906 (reported in 22 Times L. R., p. 644; also in Dicksee's "Auditing," 7th Eng. Ed., p. 872.)

The Birmingham Small Arms Company, Limited, had passed a special resolution purporting to alter the company's articles of association, the material part of which read as follows:

"In addition and without prejudice to Articles 132 and 133" (which related to the formation of and dealing with a reserve fund), "the directors may in any year in which they shall recommend a dividend to be paid on the ordinary shares . . . of not less than 10 per cent. on the amount paid up thereon set aside (without disclosing the fact) out of the earnings or profits in such year remaining after providing the amounts necessary to pay the dividends payable on preference shares and the dividend which they recommend on the ordinary shares such a sum as they may deem necessary or desirable in the interest of the company as an internal reserve

fund or as an addition to such internal reserve fund when formed, which internal reserve fund shall be held upon the terms and for the purposes following, that is to say: (*a*) The internal reserve fund shall be separate from the reserve fund under Article 132, and need not be shown or disclosed by the balance sheet, and the directors need not give any information to the shareholders as to the amount, investment, or application thereof, or otherwise in relation thereto, either in their report or otherwise. (*b*) Such internal reserve fund may be invested upon such investments (other than the shares of the company) as the directors may, in their absolute discretion, think fit, without being liable for any depreciation of or loss in consequence of such investments. . . . (*c*) Such internal reserve fund may be used and applied at the discretion of the directors for any purpose for which the ordinary reserve fund is available, or for any purposes which the directors in their absolute discretion may consider will serve, protect, or advance the interests of the company, or preserve or promote the value of the undertaking, assets, or goodwill of the company. (*d*) The directors shall disclose the internal reserve fund and the amount thereof, and all additions thereto, and all other particulars in respect to the said fund to the auditors of the company appointed by the shareholders, whose duty shall be to see that the same is applied for the purposes of the company in accordance with the provisions hereinbefore contained, but not to disclose any information with regard to the same to the shareholders or otherwise."

The shareholders of the company brought an action, declaring that the resolution was *ultra vires* and invalid, and asked for an injunction to restrain the company and its directors from acting on such a resolution. Particular exception was taken to that part of the resolution which was to prevent the auditors appointed by the shareholders from disclosing any information with regard to the same to the shareholders or otherwise. It was claimed by counsel for the plaintiff that

this would prevent the auditors from properly complying with the sections of the Companies Acts under which they were appointed and under which the auditors had to report to the shareholders. An injunction to restrain the company from acting on this special resolution was granted. In pronouncing judgment, Mr. Justice Buckley stated *inter alia* that he considered it inconsistent with the Act of Parliament (Companies' Act of 1900), that the auditor should be bound, even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders.

APPENDIX B.

Professional Ethics.

Every profession, which is worthy of the designation, must have a code of ethics which shall be observed by its members in the pursuit of their professional duties. It does not follow that the code need be written, though this has in some cases its advantages, but it is necessary that there be certain well understood principles, the violation of which shall mark the violator as unworthy of professional standing. The development of professional standards and the recognition of the underlying principles has taken many years in the older professions. This subject has had the careful attention and consideration of those engaged in the practice of accountancy, who have the welfare and the development of the profession along broad lines at heart. At the St. Paul convention of the American Association of Public Accountants, held in October, 1907, an admirable paper on "Professional Ethics" was presented by J. E. Sterrett, C. P. A., and in the course of the discussion which followed John A. Cooper, C. P. A., proposed the following:

CODE OF ETHICS.

Service.

1. To certify to statements, exhibits, schedules or other form of accountancy work, the auditing or preparation of which was not carried on entirely under the supervision of himself, a member of his firm, or one of the staff, is wrong.
2. The use of a practitioner's name in professional work by others than partners or employees is wrong in that it implies deception.
3. To perform accountancy work, payment for which is by arrangement upon the contingency of the result of litigation or other form of adjustment, is unprofessional.

4. The payment of a commission, brokerage or other form of inducement to the laity from professional fees is wrong.
5. The acceptance of any part of the fees of a lawyer or any commercial brokerage, bonus or commission, as an incident arising out of a practitioner's service, is wrong.
6. Active interest in a commercial enterprise while practicing as a public accountant is to be avoided, as incompatible with strict ethical principles.
7. The practitioner should, wherever possible, avoid acting as a trustee of special funds or pools as an incident of his calling.
8. A practitioner should avoid serving as a director in corporations in which he is professionally employed.

Clients.

1. Upon engagement a practitioner is in duty bound to tell his client of all foreknowledge he may have had touching the matter under consideration.
2. Personal responsibility is a fundamental rule of the profession. A practitioner cannot screen himself from the specific acts or laches of his employees; the responsibilities are his and those of his firm.
3. Information acquired in the course of service is privileged and inviolable. Abuse thereof to the detriment of a former client renders a member subject to the severest discipline.
4. Efforts that tend to invite or encourage legal contest, or foster further employment by neglect, manipulation or unfinished service, should be severely dealt with; it is, in fact, barratry.
5. To recommend or advise clients to a measure or course of procedure that may even indirectly give the practitioner a personal advantage must be considered as flagrant professional infidelity and misconduct. It is "maintenance," and is punishable as such at common law.

Inter-Professional.

1. Depreciation of opponents in contested matters is unprofessional and ethically wrong.
2. Acceptance of an appointment from which a colleague has withdrawn from conscientious motives, without previously making direct inquiry of such colleague as to the conditions, is professional discourtesy.
3. Canvassing the clients of a colleague for business is unprofessional.
4. To recognize or affiliate with a society that in its charter title assumes the words "Certified Public Accountant," without warrant of law as to its membership, is wrong, and gives countenance to an implied fraud.

Publicity.

1. No professional accountant should advertise or display his talents as a merchant does his wares.
2. Professional cards should show in plain inconspicuous type the name, occupation, and office address. No strained effect is consistent or dignified.
3. The same form of card may be used in publications of a recognized standard, such as technical magazines, law periodicals, etc.
4. It is not good professional form to solicit business through trade journals, flashy publications, programmes or the daily press, especially under a pseudonym or publisher's index mark.
5. The use of the public press in discussions or essays on matters of technical or general interest is legitimate.
6. The use of initials or other insignia as an affix to a practitioner's name in his business advertisements other than such as is recognized by statutory enactment in the United States or is authoritatively recognized in other countries is unprofessional.

CORPORATIONS.

1. No member should conceal his personality under a corporate name, either actual or fictitious.
2. The skill and knowledge of the profession is individual, and cannot be transferred to a corporation, the accruing goodwill is otherwise lost.
3. Success in any professional career is a matter of personality.
4. A corporation "*per se*" cannot make an audit which in the full intent of the service is a judicial function.
5. A corporation is without honor, which is the keystone of the profession.
6. Directors cannot direct in a profession of which they are not members. It is a prostitution of the financial standing of the directors and stockholders, leading to unfair competition and prejudiced decisions.
7. The ultimate profit to the lay stockholder or director, whether expressed tangibly or otherwise, is an illegitimate gain or advantage which the profession cannot countenance.
8. In the case of legal liability as the result of negligence or criminal perversion of logical facts the ultimate responsibility rests with the practitioner, notwithstanding the financial support and control of outsiders.
9. Assurance of secrecy in affairs of clients of such corporations cannot be taken seriously.
10. The profession needs no control or regulation from the laity; it is not an industry.

At the same meeting the following addition to the by-laws of the American Association of Public Accountants, pertaining to professional ethics was adopted. Mr. Cooper is entitled to the credit for this article as with the exception of rule 5 which was recommended by the Committee on Professional Ethics,

of which he was chairman, it was submitted by him through the Illinois Society of Certified Public Accountants:

Article VII of By-Laws of American Association of Public Accountants.

Professional Ethics.

The following are declared to be the fundamental rules of the Association: for (a) the infraction of any part thereof, or if (b) convicted of felony or misdemeanor, or if (c) finally declared by a court of competent jurisdiction to have committed any fraud, or is (d) held by the Board of Trustees on the written complaint of any person aggrieved, whether a member or not, to have been guilty of any act or default discreditable to the profession, or is (e) declared by any competent court or commission to be insane or otherwise incompetent, or (f) fails to pay any subscription, dues, assessment, or other sum owed by him to the Association under its by-laws within three months after such debt has become due:

A member renders himself liable to be expelled from the Association or to be suspended for a term not exceeding two years by resolution of the Board of Trustees sitting as a Trial Board.

Rules.

1. No member shall allow any person not being either a member of the Association or in partnership with him as a public accountant, or in his employ on a salary, to practice in his name as a public accountant.

2. No member shall directly or indirectly allow or agree to allow a commission, brokerage, or other participation by the laity in the fees or profits of his (the member's) professional work.

3. No member shall engage in any business or occupation conjointly with that of a public accountant, which in the opin-

ion of the Board of Trustees is incompatible or inconsistent therewith.

4. No member shall certify to exhibits, statements, schedules, or other form of accountancy work, the preparation of which was not carried on entirely under the supervision of himself, a member of his firm, one of his staff, a member of this Association or of similar association of good standing in foreign countries.

5. No member shall in his business advertisements use any initials as an affix to his name that is not either authorized by statutory enactment of this country or by the well-known associations established for a similar purpose in the British Empire, nor shall he affiliate or substantially recognize any society that is designated or in any way sets itself out to be a so-called Certified Public Accountant Society, without the State in which such society is organized having the requisite statutory enactment in full force and effect.

At the 1909 annual meeting the following additional rules were adopted:

6. No member shall agree to perform accountancy work for parties to commercial ventures or contested cases, either in prospect or instituted, payment of fee for which is by arrangement based upon the contingency of the results.

7. No member shall interfere, or in any way take part in any effort looking to the modification, alteration, or amendment of any State laws affecting the profession of accountancy without the concurrence and co-operation of the society or societies of the State or district concerned, unless such action shall not violate any of the fundamental rules of the Association.

APPENDIX C.

Report of a Case bearing upon the question of the Liability of Directors for the payment of Dividends out of Capital instead of Profits, as provided in the Corporation Laws of New York and New Jersey.

ARCHIBALD A. HUTCHINSON and VICTOR K. MCELHENY, Jr., on Behalf of Themselves and All Other Stockholders of the American Malting Co., Similarly Situated, *Plaintiffs,*

v.

ALEXANDER M. CURTISS and THE AMERICAN MALTING CO., *Defendants.*

(SUPREME COURT, NEW YORK SPECIAL TERM, DECEMBER, 1904, 92 N. Y. Supp. 70.)

Liability of director of foreign corporations for making unauthorized dividends—Payment of dividends on preferred stock must be made from profits, not from capital—Expectation of future profits on contracts not to be figured as assets—Effect of absence of director when such unauthorized dividends declared—Losses through payment of commissions on sale of bonds.

The statutes of this State allow the recovery, from directors of a foreign corporation, of dividends unauthorized by the laws under which such corporation is organized. It is the foreign statute that makes the dividends unauthorized, but the recovery is to be had under the New York statute.

No dividends can be made except from "surplus or net profits."

Contracts, entered into by a corporation, for future deliveries of a product not yet made by it, from raw material not yet purchased, cannot be taken as assets in figuring said surplus or net profits. Dividends cannot be made on a mere hope or expectation of profits.

Where raw material is bought by weight, and after manufacture is increased in weight and value, the corporation is entitled to treat it as an asset at its increased value.

A director, who is not present when an unauthorized dividend is declared, is not liable under the statute, even though he is present at a subsequent meeting when the minutes of the former meeting are ratified.

A director, sued for unauthorized dividends, cannot be credited with the profits which subsequently accrued under a change of management.

A director is not liable for commissions, paid on the sale of bonds of a corporation which had made unauthorized dividends, in the absence of proof of fraud and conspiracy for the defendant's personal benefit; such loss is included in the loss caused by the illegal dividends which defendant must pay.

Action against director for making unauthorized dividends.

CLARKE, *J.*:

The American Malting Company was organized under the laws of New Jersey, September 28, 1897. It began business on October 11, 1897. On October 15, 1897, it filed a copy of its charter in the office of Secretary of State of New York to enable it to do business in this State, and received the usual certificate for that purpose. The principal office of the company was situated in the City of New York, at No. 80 Broadway, from its organization until the fall of 1899, and since then it has been situated continuously at East River and Sixty-

third Street, New York City. The company has had no plant or property in New Jersey. It has kept no bank account there. It had merely a formal, statutory office in that State. Its capital stock is $30,000,000, divided into 300,000 shares of $100 each, of which 144,400 shares of preferred stock and 145,000 shares of common stock have been issued. The preferred stock is seven per cent. cumulative, having a preference as to dividends only. The company is engaged in the manufacture and sale of malt. Its stock was issued to promoters for twenty-one malting establishments, situated in various parts of the United States, on which they had acquired options, and for $2,080,000 cash working capital. No stock in trade was, however, acquired by the issue of stock. As soon as the organization was effected the company was compelled to purchase from the vendors of the various malting plants their stocks of barley and malt, for which the company issued its obligations, amounting to upward of $1,600,000. A little over two months after the company began business, and on December 20, 1897, the board of directors declared a dividend of one and three-fourths per cent. to preferred stockholders, payable January 15, 1898. This amounted to $219,450. Thereafter a dividend at the same rate was declared and made payable at each of the following dates: April 15, 1898, $219,450; July 15, 1898, $219,450; October 15, 1898, $219,450; January 15, 1899, $219,450; April 15, 1899, $252,700; July 15, 1899, $252,700; October 15, 1899, $252,700. In all $1,855,350. Barely two weeks after the payment of the dividend of October 15, 1899, and on November 2, 1899, the minutes of the board of directors disclosed its serious financial condition as reported to said board, viz., its outstanding obligations amounted to $2,800,000 in notes; that the officers were unable to negotiate further temporary loans; that the company needed additional working capital, and that the board authorized the sale of $4,000,000 mortgage bonds of the company. Said bonds, six per cent. fifteen-year gold mortgage bonds, were subsequently disposed of at a discount of $400,000. This is an action brought by plaintiffs as stockholders on behalf of themselves and all other

stockholders similarly situated against the defendant Curtiss as director of the company to compel him to account for and pay to the company the amount of the dividends declared and paid as not having been paid out of the profits, but out of the capital. The board of directors having upon demand refused or neglected to bring suit in the name of the company, it was joined as a party defendant. At first the company put in a defense, but subsequently, its management having changed, it obtained leave to file an amended answer admitting the allegations of the complaint and joining in the prayer of the plaintiffs for the relief demanded. In a similar action against another of the directors the complaint was dismissed upon the trial. Upon appeal the Appellate Division reversed that judgment. *Hutchinson v. Stadler,* 85 App. Div. 428. That case settled the law for this court to this extent; that an action could be maintained in the courts of this State against a director of a New Jersey corporation to recover the amount of dividends declared in violation of the laws of that State. Two opinions were handed down, in which the learned justices arrived at the conclusion that the action could be maintained upon different grounds. With each of these opinions a justice concurred. The fifth learned justice concurred in the result. I cite this division of opinion because this court is now called upon to apply the law, as laid down with this practical embarrassment, that while it was the unanimous decision that the action could be maintained, yet the difference in the grounds therefor means a difference of hundreds of thousands of dollars in the judgment I am about to order. As I interpret it that case holds this court has jurisdiction, because section twenty-three of the Stock Corporation Law of this State provides: "The directors of a stock corporation shall not make dividends, except from the surplus profits arising from the business of such corporation; nor divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital of such corporation, or reduce its capital stock, except as authorized by law. In case of any violation of the provisions of this section, the directors under

whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes of such directors at the time, or were not present when the same happened, shall jointly and severally be liable to such corporation and to the creditors thereof to the full amount of the capital of such corporation so divided, withdrawn, paid out or reduced;" and because section thirty of the General Corporation Law of New Jersey provides: "No corporation shall make dividends, except from the surplus or net profits arising from its business, nor divide, withdraw or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this act, and in case of any violation of the provisions of this section the directors under whose administration the same may happen shall be jointly and severally liable at any time within six years after paying such dividends to the corporation and to its creditors in the event of its dissolution or insolvency to the full amount of the dividend made or capital stock so divided, withdrawn, paid out or reduced, with interest on the same from the time such liability accrued; provided that any director who may have been absent when the same was done, or who may have dissented from the act or resolution by which the same was done, may exonerate himself from such liability by causing his dissent to be entered at large on the minutes of the direcors at the time the same was done, or forthwith after he shall have notice of the same, and by causing a true copy of said dissent to be published within two weeks after the same shall have been so entered in a newspaper published in the county where the corporation has its principal office;" and because section sixty of the Stock Corporation Law of this State provides: "Except as otherwise provided in this chapter the officers, directors and stockholders of a foreign stock corporation transacting business in this State, except moneyed and railroad corporations, shall be liable under the provisions of this chapter, in the same manner and to the same extent as the officers, directors and stockholders of a domestic corporation

for: 1. The making of unauthorized dividends . . . Such liabilities may be enforced in the courts of this State, in the same manner as similar liabilities imposed by law upon the officers, directors and stockholders of domestic corporations." That is, by virtue of the statutes, this State allows the recovery of dividends unauthorized by the State of New Jersey from directors of a New Jersey corporation in the same manner and to the same extent as the directors of a domestic corporation. That is, it is the New Jersey statute which makes the dividend unauthorized, but the recovery is to be had according to the New York statute. What, then, is unauthorized? "No corporation shall make dividends except from the surplus or net profits arising from its business." Net profits are defined in the Century Dictionary as "what remains as the clear gain of any business after deducting the capital invested in the business, the expenses incurred in its management and the losses sustained by its operation." And the controlling question of fact is, were these dividends paid from "net profits"?

The twenty-one branches, located in many places and in different States, which were actually engaged in the business of manufacturing the malt from the barley, sent in to the general office in New York daily, weekly and monthly statements in great detail of their business. From these statements branch books were made, and from these a general set of books was prepared. All of the books and papers from the general office, which were used in the accounting department, were produced in court, identified and marked in evidence. The defendant objects to the summaries made up from these books, and from any and all conclusions of fact to be drawn from said books and said summaries upon the ground that concededly the contracts and the contract books were not produced and were not considered. It was in evidence that malt was always oversold, that contracts for future deliveries, running over many months, were entered into, and the claim is that such contracts were required to be taken into considera-

tion when it came to be determined whether any particular dividend was warranted or not. Such claim, in my opinion, is unfounded. The law is that "No corporation shall make dividends except from the surplus or net profits." These contracts were to deliver at a future time a product not yet made from raw material, not yet purchased, with the aid of labor not yet expended. The price agreed to be paid at that future time had to cover all the possible contingencies of the market in the meanwhile and might show a profit, and ran the chance of showing a loss. When the sales actually took place they were entered in the books. But to calculate months in advance on the results of the future transactions, and on such calculations to declare dividends, was to base such dividends on paper profits—hoped for profits, future profits—and not upon the surplus or net profits required by law. It does not seem to me that you can "divide," that is, make a dividend of a hope based on an expectation of a future delivery at a favorable price of what is not yet in existence, under the statute. So the objection to the books upon that ground is of no weight. From the books certain statements were made up for the aid of the court upon different theories and in different ways. One set of statements was testified to be exactly what the books showed, without the change of a figure. These exhibits are known as 10 P, 10 Q. As to these statements I do not understand that there is any controversy as to the accuracy of the figures. A second statement, known as 10 R, 10 S, is identical with the foregoing, with the elimination of one entry, which, as a matter of act, was eliminated by the company itself some months after its entry. There was entered on the books on the 31st of December, 1898, an item of $388,063.36 of the anticipated or estimated future profits on contracts for future deliveries running over many months. This entry, for the reasons stated in regard to the contracts for future deliveries, was unjustifiable. The company subsequently removed this entry. The actual transactions, that is, the deliveries of the malt called for by the contracts and the receipts in payment therefor being reported from time to

time as they occurred, resulting in double credits, the cancellation or reversal of the entry was absolutely required. On the other hand, I find against the plaintiffs in regard to their contention as to the increase account. Barley is bought by the bushel of forty-eight pounds. Malt, the manufactured article made from barley by steeping, is dealt in by the bushel of thirty-four pounds. The process of manufacture produces about fifteen per cent. more of malt by the bushel than the barley measures from which it is produced. The amount of this fifteen per cent. excess is reported from each of the manufactories month by month as increase. Of course, this increase has a value, as it is sold as malt at malt prices. For the purpose of inventory the company has ascribed to it the value of the barley. This, plaintiffs claim, is error, because that amount has already once been charged to malt account, and they say this increase should have no value ascribed to it until sold and delivered, when its proceeds go into the books as cash. But it certainly is an asset of the company, and as an asset at inventory periods, or when it is necessary to ascertain the actual condition of the company, it must be valued in some way. As it has always been the custom in the malting business to treat it as treated by this company, I am unwilling to disregard that custom. The accounts upon which I based my conclusions treated it as this company did. I find that at the time of the declaration and payment of the third dividend, July, 1898, a deficit was caused thereby of $142,774.59, and from that time to the end of the period under consideration none of the dividends were paid out of net profits, but all were paid out of capital. But it appears that defendant, Curtiss, was not present at the meeting on February 28, 1899, when the dividend paid April 15, 1899, was authorized. Under the New York statute—under which we are proceedings—a director who was not present when the dividend was declared is not liable. The approval of the minutes at the following June meeting at which he was present, was only the authentication of the proof of what had happened at the previous meeting. He is, therefore, not to be held liable for

that dividend. He is liable, in my judgment, as follows: For dividends paid July 15, 1898, to the extent of $142,774.59; October 15, 1898, $219,450; January 15, 1899, $219,450; July 15, 1899, $252,700; October 15, 1899, $252,700—$1,087,074.59, with interest thereon from the several dates of payment. As the highest court of New Jersey, interpreting the law of the State under which this company was incorporated held, "for the full protection of the company the liability of the directors must be absolute" (*Appleton v. Am. Malting Co.*), I find against the defendant upon his claim that the accrued profits of the company, made under a changed management, can be credited in his favor against his liability. It is claimed that this is a harsh law. If it were, such complaint should be made to the Legislature and not to the court. It does not seem to me that in these days of great corporations and of combinations into one of many corporations it is asking too much of directors, fiduciary officers as they are, that they should obey the law of their incorporation, and not bring their companies to the verge of bankruptcy and ruin by the payment of quarterly dividends on preferred stock out of capital instead of net earnings. As to the second cause of action: While the allegations are profuse as to a "wilful, fraudulent and illegal conspiracy," the proof failed to establish that there was any such conspiracy for defendant's personal benefit. The cases establishing the cause of action pointed at in these allegations have been where directors have diverted to themselves for their own benefit the property of the company. The damage here flowed out of the making of the dividends, if any there was. It was alleged that the company had to issue bonds, and that the commissions, discounts and interest thereon amount to $650,000, which, as a waste of its funds, the plaintiff seeks to recover. But as I find that this flowed as a damage only from the declaration and payment of the dividends I am persuaded by the language of Mr. Justice Hatch in *Hutchinson v. Stadler supra* that it does not under the facts of this case constitute a separate cause of action. He says: "In point of fact that statute of the State of New Jersey upon

this subject as well as our own, does little more than lay down a rule of damage to be enforced against directors for breach of duty. At common law a recovery could be had for the waste but the extent of the recovery would depend upon the damage sustained by the corporation and be the subject of proof. The statute measures the loss sustained, which is usually the correct amount, and authorizes a recovery therefrom of the individuals who produced that result." It seems to me that any other theory would result in turning the amount recovered for illegal dividends into a penalty. The Court of Errors and Appeals of New Jersey in this very matter, as well as our Appellate Division, have held: "The liability imposed by the statute is not penal in its character. Its sole purpose is not to punish, but to provide for the making of compensation by wrongdoers for the injury sustained by their wrongful act." This alleged loss must, therefore, be held to have been included in that for which the defendant is required to make compensation by paying into the company an amount equal to the illegal dividends.

APPENDIX D.

Forms of Accounts.

In Chapter VII mention was made of the fact that various governmental bodies had prescribed classifications of accounts and forms of report for corporations coming within their jurisdiction, and that the American Association of Public Accountants and other bodies had also been active in devising improved forms for uniform use by various undertakings. Nearly all of the forms now submitted are of recent compilation, and will no doubt be improved from time to time. Nevertheless the practitioner and student may find suggestions of value in these pages. Criticisms for future use will be welcomed by the editor.

The source from which each of the forms has been drawn is given. As the forms of reports to governmental bodies are usually quite voluminous, including many schedules for historical use and much statistical data which are not of sufficient importance to warrant their reproduction in full, a selection has been made of those parts which are of general interest to accountants.

STEAM RAILROAD COMPANIES.

The field in which governmental regulation first took the form of actually prescribing the manner in which the accounts themselves should be kept, as distinguished from the requirement that reports should be made on a prescribed form, was that of interstate common carriers, chief among which are steam railroads. Except as noted, the following forms are those prescribed by the Interstate Commerce Commission.

*Form 1. Balance Sheet.

The Interstate Commerce Commission has not yet prescribed a standard form of balance sheet. The form here submitted is

* For convenience the forms follow the entire descriptive matter. See pages 411 *et seq.*

a modification of the form of report required to be made by steam railroads to the Commission for the year ended 30th June, 1908.

This form does not show all the details which it might be desirable in the case of some companies to show. There will frequently be special items which ought to be stated separately, but they will usually fall under one of the general heads shown on this form.

Form 2. Statement of Capital Expenditures.

A separate tentative classification of "Additions and Betterments" has also been issued by the Commission, but this is not yet final nor is its use compulsory.

The totals of this statement appear in the Balance Sheet (Form 1) under the caption "Road and Equipment."

Form 3. Income Account.

In describing the balances shown at the various rests in the account the terms "Revenue" and "Income" would necessarily become "Deficit" and "Loss" if expenditure exceeded income.

Form 4. Profit and Loss Account.

This is the form prescribed by the Interstate Commerce Commission, slightly modified.

If the Income Account (Form 3) for the year shows a loss instead of a profit, the balance thereof would naturally appear on the debit instead of the credit side of the Profit and Loss Account. Similarly, if instead of having a surplus at the date of the balance sheet, the company has a deficit, the balance of the Profit and Loss Account would be stated as a debit balance, instead of a credit balance, as shown in this form.

Form 5. Detailed Statement of Operating Revenues.

Form 6. Detailed Statement of Operating Expenses.

The totals of these statements are entered in the Income Account (Form 3).

For independent companies operating 250 miles or less and having annual operating revenues not exceeding $1,000,000, and for terminal and switching companies, the Commission has promulgated a condensed classification of operating expenses. The five general accounts are the same for both classes of roads, but the 116 primary accounts of the extended classification are reduced to 44 accounts in the condensed classification.

Form 7. Summary of Revenues and Expenses of Outside Operations and other Properties.

This form shows the different operations carried on by railroad companies which the Commission has officially designated as "outside operations," and the revenues and expenses of which are now stated separately from those which are directly incidental to transportation by rail.

The totals of section "A" of this summary are entered in the Income Account (Form 3), while the net profit or loss shown by section "B" is entered in the Profit and Loss Account (Form 4).

Detailed classifications of operating accounts have also been prescribed by the Commission for each class of operations included in this form.

PUBLIC SERVICE CORPORATIONS AND MUNICIPAL INDUSTRIES.

Attention has already been directed to the importance of the subject of accounts pertaining to public service corporations.

Form 8. Standard Schedule of Revenue and Expense for Municipal Industries and Public Service Companies.

This is the form as amended by a committee appointed by the American Association of Public Accountants and submitted at the 1907 convention of the Association.

This is a condensed form which is applicable to any form of public utility—transportation, electric or gas lighting, water supply, telephone, etc.—and would be supported by detailed schedules containing the details pertinent to each particular utility.

It should be of especial value in comparing the operations of different enterprises, as it is designed to bring out very clearly how the items, the treatment of which is more or less a matter of judgment (*e. g.*, depreciation), or which for other reasons may be considered as "variables," have been handled.

ELECTRIC RAILWAY COMPANIES.

These forms are based on the classification prescribed by the Interstate Commerce Commission for use from 1st January, 1909, by electric railways subject to its jurisdiction. In a preliminary letter the Commission stated that it was working in conjunction with the various state bodies having jurisdiction over electric railways. This being so, the probability is that the classification of accounts promulgated by the Commission will eventually be adopted by the various state commissions and become the uniform system of accounts for electric railways. As noted in Chapter IV, the New York Public Service Commissions have already prescribed classifications very similar in their general outline to the Interstate Commerce Commission classification, though somewhat more elaborate.

The form of balance sheet, income account and profit and loss account for electric railway companies would differ only in minor details from those for steam railroad companies (see Forms 1, 3 and 4), and hence are not submitted. The classi-

fications of construction, earnings and operating expense accounts, however, are given in the following forms:

Form 9. Classification of Expenditures for Road and Equipment.

Form 10. Statement of Operating Revenues.

Form 11. Statement of Operating Expenses.

Two condensed classifications of operating expenses have been promulgated for small companies, one of 58 accounts, instead of the full number of 88, for companies having annual operating revenues of $250,000 to $1,000,000, and another of 36 accounts for companies with annual operating revenues of less than $250,000. The classifications of construction expenditures and operating revenues are the same, however, for all companies.

ELECTRIC LIGHT, HEAT AND POWER COMPANIES AND GAS COMPANIES.

The systems of accounts prescribed by the Public Service Commissions of New York for the corporations subject to their jurisdiction are the basis of the forms shown herewith.

Form 12. Balance Sheet.

is for a company engaged in producing and supplying both electricity and gas. For a company supplying only one or the other of these commodities, the details under the heading of Plant pertaining to that used in either electric or gas operations would be eliminated and one of the items of Material and Supplies under Current Assets would fall out; otherwise the balance sheet would be unchanged.

As the Commissions have not yet prescribed a definite form of balance sheet, since promulgating the classifications of accounts which became effective 1st January, 1909, the form herewith is a modification of the form in use by the Commis-

sion for the Second District up to this time. It will be noticed that the capital stock is shown after the actual liabilities and in juxtaposition to the surplus.

Form 13. Income Account

is also for company engaged in supplying both electricity and gas. For a company supplying only one or the other, one of the groups of Operating Revenues and Expenses would fall out, and if no "outside operations" are carried on the group bearing that designation would likewise be eliminated. In other respects the form would be the same.

Form 14. Statement of Corporate Surplus Account. (Profit and Loss.)

Form 15. Classification of Accounts for Electric Light, Heat and Power Companies ("Electrical Corporations").

Form 16. Classification of Accounts for Gas Companies.

Three condensed classifications of both electric and gas operating expense accounts have been issued for small companies, the companies being divided into the following classes:

Gross Operating Revenues...$100,000 to $500,000 per annum
" " " ... 25,000 to 100,000 "
" " " ... less than 25,000 "

WATER SUPPLY SYSTEMS.

In the autumn of 1908 the Bureau of the Census published in connection with its report for the year 1906 on the "Statistics of Cities Having a Population of Over 30,000," an appendix dealing with the subject of "Uniform Accounts and Reports of Water-supply Systems." In addition to presenting the results of an exhaustive study of the subject by Dr. L. G. Powers, Chief Statistician of the Bureau (in which he had the co-operation of Mr. Moses N. Baker, Associate Editor of the *Engineering News,* and conferred with a committee of the

American Association of Public Accountants, as well as with other organizations) a comprehensive scheme of uniform accounts for water-supply systems is submitted.

Emphasis is laid on the fact that "uniform accounts (are) the only basis for comparable statistics" and that "questions of municipal ownership and of municipal control over water and other public utility enterprises are demanding more perfect, as well as uniform, accounting for these enterprises."

Any one having occasion to deal with the accounts of water-supply systems should procure the publication referred to, from which the annexed forms are reproduced. The statement is made that "the water supply schedules which the Bureau of the Census presents herewith for constructive criticism result from an attempt to set forth in logical and functional order all the more pertinent facts relating to the construction and operation of municipal water-supply systems. If the schedules are too extensive and too detailed, it is because the aim has been to make them ideally inclusive with the idea that they may be shortened, if necessary, to make them practicable for actual use. . . .

" . . . five orders of accounts are suggested, viz.:

1. Summary or controlling accounts.
2. General accounts, indicated by Roman numerals.
3. Sub-general accounts, indicated by capital letters.
4. Primary accounts, indicated by Arabic numerals.
5. Sub-primary accounts, indicated by small letters.

The summary, general and subgeneral accounts are arranged for the purpose of grouping the different items of income and expenditure, and of property and equipment under certain general heads, so as to admit of their presentation in a condensed form in publishing reports and statistical summaries. The subgeneral accounts may also be used as the only, or at least the principal, accounts of small water-supply enterprises, with a gross annual income not exceeding $25,000, whose operations do not warrant greater detail in accounting. The

primary accounts are provided for the use of the larger systems—those having a gross annual income of $25,000 or over. Cities and corporations operating such systems may also use subprimary accounts in whatever detail they may desire. No suggestion is here made for such accounts other than that they should be so arranged as to be subordinate to the primary accounts mentioned in the tentative scheme of accounts."

Form 17. Tentative Classification of Operation Accounts.

Form 18. Allocation Accounts.

Form 19. Property Accounts.

Attention is also called to the value of combining the information obtained from the financial accounts with that presented by the physical statistics, or, in other words, cost accounting.

Form 20. Is a Suggestion for a Condensed Analytical Cost Accounting Summary.

The following forms comprise the Proposed Census Schedule for Securing Uniform Reports of the Transactions and Condition of Water-Supply Enterprises:

Form 21. Part I, Financial Transactions for the Year.

Form 22. Part II, Summary of the Cost of Water-Supply System and of Its Extensions, Additions, and Renewals.

Form 23. Part III, Condensed Balance Sheet.

It will be seen that Part I is a statement of earnings and operating expenses and a profit and loss account. Exception may be taken to including in gross income from, and expenses of, operation such items as earnings and expenses of invested funds and interest on cash balances in bank. These should be shown under a separate heading, say, Other Income, in the profit and loss account. It would also be well to segregate the earnings and expenses of accessory enterprises, the operation of which by a water-supply company is optional. In other

words, in stating the profit and loss or income account the gross earnings and the operating expenses directly incident thereto, and the gross profit or net earnings resulting from, the supplying of water, should be shown separate from accessory enterprises (similar to the "outside operations" of railroads) and miscellaneous income, otherwise the basis of comparison between different systems is lost.

It should be noted that the system of accounts proposed by the Census Bureau is for use by both municipalities and private corporations. The principal points of divergence would be in the "allocation" section of the income or profit and loss accounts and the "proprietary interests" section of the balance sheet.

BANKS.

Form 24. Form of Report Required to Be Made by National Banks to the Comptroller of the Currency

on the occasion of a call by him for the condition of national banks throughout the country. Section 5211 of the Revised Statutes of the United States provides that the Comptroller must make at least five such calls, as a day already past, during each year.

Unlike the procedure in the regulation of railroads, the government, in its supervision of national banks, does not prescribe a certain classification of accounts. Common sense, however, would suggest the keeping of the accounts in such a way as to facilitate the ready preparation of the reports called for.

The forms of report for state banks, trust companies and savings banks vary with the states in which the institutions are located and sometimes contain special features; *e. g.*, the law of the State of New York requires state banks and trust companies to state their deposit liabilities in two classes, "preferred deposits," the payment of which, in case of insolvency, is preferred by law or otherwise over other deposits, and "other deposits."

BUILDING AND LOAN ASSOCIATIONS.

Aside from the apportionment of profits among the various series of stock, the stating of building association accounts involves no unusual features. The accounts usually published are in one respect subject to the same criticism as those of life insurance companies, in that they seldom contain a profit and loss account but only a statement of receipts and disbursements. The latter is, however, a valuable statement and should not be omitted even when a profit and loss account is submitted, as it shows, among other things, the volume of transactions which could otherwise be ascertained only by a laborious analysis and comparison of the current balance sheet and the one preceding.

Building and loan associations are chartered by the states, and are usually subject to the supervision of the state banking department. The form of report required to be made varies in the different states. The annexed forms are a combination of the best ones in use.

Form 25. Balance Sheet.

Form 26. Profit and Loss Account.

Form 27. Receipts and Disbursements.

Form 28. Statement of Share Capital.

Some associations, though not many, accompany the last statement by a tabulated exhibit of the dues paid in and profits per share for each unmatured series in each year of its existence, and the percentage of the profit earned each year. Combined with the statements above enumerated, this makes a very complete exhibit of the condition and earnings of an association.

INSURANCE COMPANIES.

Why insurance companies have continued to transact business with such primitive accounting systems as most of them have, or have had until recently, is difficult to understand. It

may be due in part to the fact that the forms of reports required by the state departments having supervision over insurance companies have encouraged, if not actually approved, unscientific methods of accounting. The distinction between "ledger" and "non-ledger" assets is an instance in point; the incomplete cash account which is published in lieu of a proper income and expenditure account is another.

At the time of the New York life insurance investigation several years ago, the matter of requiring better accounting methods on the part of the companies and the submission of reports prepared along proper lines received the attention of the American Association of Public Accountants, a committee of which, acting jointly with a committee of the New York Society of Certified Public Accountants, appeared before the Armstrong Committee of the New York State Legislature and presented the necessity for reform in accounting methods in a very forcible manner.

A report of the Committee's criticisms and suggestions appeared in the April, 1906, *Journal of Accountancy*.

The following forms of account, copies of which are annexed, were suggested:

Form 29. Balance Sheet.

Form 30. Assurance Account and Surplus Account.

Form 31. Analysis of Agency Expenses.

Form 32. Analysis of Administration and General Expenses.

It is to be regretted that the forms suggested were not adopted, as they are far superior to the forms ordinarily used, and give in a concise way the information which is of vital interest to the policy or stock holder. By means of supplemental schedules they can be amplified to any extent desired.

To show the contrast between these forms and those in use by the state departments, the principal schedules in the voluminous report called for by the Insurance Department of New

York (which is the form in use by most, if not all, of the other states) are shown herewith as Form 33. It will be noticed that an analysis of the increase or decrease in the surplus is now called for, though this form is very cumbersome; this may be ascribed in part at least to the incomplete accounts from which it must be prepared. The editor does not recollect having ever seen this exhibit included in any of the statements published by the companies for the information of their policyholders.

While these model forms are primarily for life companies, the balance sheet, and assurance and surplus accounts can, by proper modification, be adapted for use by fire and other companies.

MANUFACTURING AND MERCANTILE ENTERPRISES.

Here is where the greatest diversity of form is naturally to be expected. While detailed forms suitable for any and every business of this character cannot be prepared, yet the essentials of a balance sheet and income account can be pointed out. The annexed forms are submitted more for this purpose than with any thought that they can be used without modification.

Form 34. Form of Balance Sheet

prescribed by the English Companies Act, 1862 (Table "A"). (The asset and liability sides have been transposed to accord with the general American practice.)

There is much to be said in favor of this form, and despite the fact that it had been in use for forty-six years, and hence might be thought to require reconsideration, no change was made therein at the time of passing the 1908 Companies Act.

Form 35. Form of Balance Sheet

submitted by Mr. G. S. Pitt in a paper on "Forms of Published Accounts of Trading Concerns and Some Observations

on Their Audit," read at the 1908 Autumnal Conference of the Society of Incorporated Accountants and Auditors. In the words of Mr. Pitt: "It is not suggested that this form is suitable for general adoption. It has been prepared with a view to illustrate the manner in which particular items should be stated." Mr. Pitt laid special emphasis on the importance of showing "the liquid assets added up in total on the one side, and cash liabilities added up in total on the other side."

Mr. Pitt's paper and a report of the discussion which followed its presentation will be found in *The Accountant* of 3rd October, 1908.

As with the preceding forms, the asset and liability sides are transposed on the form herein.

Form 36. Form of Balance Sheet

recommended to the Company Law Committee by the Society of Incorporated Accountants and Auditors in 1906.

In the form herewith the asset and liability sides have been transposed and some other slight modifications made for the convenience of American practitioners and students.

Form 37. Balance Sheet for Manufacturing Companies.

This is a form combining the best features of published American reports. This form can also be used for a consolidated balance sheet by entering in the Capital Stock section an item of Stock of Subsidiary Companies Not Owned by Holding Company, if any, and including the proportion of surplus of subsidiary companies accruing to the holders of such stock, among the liabilities.

Form 38. Balance Sheet for Trading Firm.

A very simple form which can readily be amplified, as to detail, to any extent desired.

Form 39. Profit and Loss Account.

Submitted by Mr. A. Lowes Dickinson, C.P.A., F.C.A., in his paper on "The Profits of a Corporation," which was read at the Congress of Accountants in 1904. This form "already in fairly general use, is submitted as the most complete short form and by means of exhibits it is capable of amplification to any extent desirable."

Form 40. Profit and Loss Account for Trading Firm.

A simple form also capable of amplification to any extent.

Form 41. Standard Form of Borrowers' Statement.

This form has been officially adopted by the New York State Bankers' Association and is believed to be the most complete "short" form in use.

The question "Have the books been audited by a Certified Public Accountant?" was suggested some years ago by Mr. James G. Cannon, Vice-President of the Fourth National Bank of New York, one of the foremost bankers of the country.

Mr. Cannon's influence has resulted in a more general appreciation by bankers of the services of public accountants.

If bankers would uniformly insist on the certification of borrowers' statements by professional accountants they would save millions of dollars through the elimination of doubtful loans.

MUNICIPAL REPORTS.

The movement for uniform municipal reports, which has received the attention of such organizations as the National Municipal League, as well as of accountants, economists and others, for a considerable number of years past, has made especial progress during the past few years.

Whereas it was at one time seriously questioned whether there could be uniformity in either the accounts or reports of municipalities, it is now recognized that there can be uniformity in reports, and that the keynote "is the classification of the receipts and payments (or revenue and expenses) of

cities upon a common basis along functional lines, so that the relative cost of government and of any governmental function of one city can be compared within reasonable limits with the corresponding costs for other cities." (L. G. Powers, U. S. Census Bureau.)

Form. 42. Classification of Receipts and Payments Used by the United States Bureau of the Census

in preparing its reports on the statistics of cities; this classification has been unanimously recommended by the National Municipal League and League of American Municipalities, the latter organization including many Canadian cities.

The movement for municipal balance sheets has not yet resulted in any considerable number of cities publishing such statements, and it will doubtless require an extensive educational campaign before it will be the general custom for American municipalities to issue balance sheets prepared on scientific lines. It is, however, sure to come.

THE.....RAILROAD COMPANY

BALANCE SHEET.....19

ASSETS:

ROAD AND EQUIPMENT:		
Cost of Road	$.....	
Cost of Equipment	.....	
General Expenditures	.....	
		$.....
LANDS OWNED		.....
OTHER PERMANENT INVESTMENTS (Specify)		.....
		$.....
SECURITIES OWNED:		
Stocks	$.....	
Bonds	.....	
		.....
ADVANCES TO CONTROLLED OR AFFILIATED COMPANIES		.....
CURRENT ASSETS:		
Materials and Supplies	$.....	
Bills Receivable	.....	
Traffic Balances due from other Companies	.....	
Due from Agents	.....	
Miscellaneous Accounts Receivable	.....	
Cash	.....	
		.....
SINKING AND SPECIAL FUND ASSETS:		
(Specify)	$.....	
		.....
		$.....

LIABILITIES:

CAPITAL STOCK		$.....
(If more than one class, specify)		.....
		$.....
FUNDED DEBT:		
(Specify, stating nature, rate of interest, and due date)	$.....	
DUE CONTROLLED OR AFFILIATED COMPANIES		.....
CURRENT LIABILITIES:		
Bills Payable	$.....	
Audited Vouchers	.....	
Pay Rolls	.....	
Traffic Balances due other Companies	.....	
Accrued Taxes	.....	
Accrued Interest on Funded Debts	.....	
Accrued Rentals	.....	
Miscellaneous	.....	
		.....
SINKING AND SPECIAL FUNDS:		
(Specify)		.....
.....		.....
PROFIT AND LOSS (undivided profits)		.....
		$.....

EXPENDITURES FOR ROAD

Account	Expenditures for New Lines or Extensions During Year		Expenditures for Additions and Betterments During Year			
	Charged to Capital	Charged to Special Funds or Income	Charged to Capital	Charged to Special Funds or Income	Total Cost to June 30, 1907	*Total Cost to June 30, 1908
ROAD:	$	$	$	$	$	$
Engineering						
Right of Way and Station Grounds						
Real Estate						
Grading						
Tunnels						
Bridges, Trestles, and Culverts						
Ties						
Rails						
Frogs and Switches						
Track Fastenings and Other Material						
Ballast						
Track Laying and Surfacing						
Roadway Tools						
Fencing Right of Way						
Crossings and Signs						
Interlocking and Other Signal Apparatus						
Telegraph and Telephone Lines						
Station Buildings and Fixtures						
General Office Buildings and Fixtures						
Shops, Enginehouses, and Turntables						
Shop Machinery and Tools						
Water Stations						
Fuel Stations						
Grain Elevators						
Storage Warehouses						
Dock and Wharf Property						
Electric-Light Plants						
Electric-Power Plants						
Electric-Power Transmission						
Gas Producing Plants						
Miscellaneous Structures						
Transportation of Men and Material						
Rent of Equipment						
Repairs of Equipment						
Earnings and Operating Expenses during Construction						
Injuries to Persons						
Cost of Road Purchased						
TOTAL	$	$	$	$	$	$

*Add the amounts in the two columns headed "Charged to Capital" to those in the column headed "Total Cost to June 30, 1907" to obtain the totals for the last column.

(Form 2)

EXPENDITURES FOR EQUIPMENT, GENERAL EXPENDITURES, AND RECAPITULATION.

ACCOUNT	Expenditures for New Lines or Extensions During Year. Charged to Capital	Expenditures for New Lines or Extensions During Year. Charged to Special Funds or Income	Expenditures for Additions and Betterments during Year. Charged to Capital	Expenditures for Additions and Betterments during Year. Charged to Special Funds or Income	Total Cost to June 30, 1907	*Total Cost to June 30, 1908
EQUIPMENT:						
Steam Locomotives	$	$	$	$	$	$
Electric Locomotives						
Passenger-Train Cars						
Freight-Train Cars						
Work Equipment						
Floating Equipment						
Total,	$	$	$	$	$	$
GENERAL EXPENDITURES:						
Law Expenses	$	$	$	$	$	$
Stationery and Printing						
Insurance						
Taxes						
Interest and Commissions						
Other Expenditures						
Total,	$	$	$	$	$	$
RECAPITULATION						
ROAD	$	$	$	$	$	$
EQUIPMENT						
GENERAL EXPENDITURES						
Total,	$	$	$	$	$	$
Cost of Road per Mile of Line					$	$
Cost of Equipment per Mile of Line						
General Expenditures per Mile of Line						
Total per Mile of Line					$	

* Add the amounts in the two columns "Charged to Capital" to those in the column headed "Total Cost to June 30, 1907" to obtain the totals for the last column.

(FORM 2—Concluded)

(STEAM RAILROAD)

INCOME ACCOUNT

Year ended.....19...

OPERATING INCOME:		
Rail Operations:		
Operating Revenues	$....	
Operating Expenses	....	
NET OPERATING REVENUE		$....
Outside Operations:		
Revenues	$....	
Expenses	....	
NET REVENUE		....
TOTAL NET REVENUE		$....
Taxes Accrued		....
OPERATING INCOME		$....
OTHER INCOME:		
*Other Rents—Credits:		
(a) Hire of Equipment—Balance	$....	
(b) Joint Facilities	....	
(c) Miscellaneous Rents	....$....	
*Separately Operated Properties—Profit		....
Dividends Declared on Stocks Owned or Controlled		....
Interest Accrued on Funded Debt Owned or Controlled		....
Interest on Other Securities, Loans, and Accounts		....
Miscellaneous Income		....
TOTAL OTHER INCOME		....
GROSS CORPORATE INCOME		$....
DEDUCTIONS FROM GROSS CORPORATE INCOME:		
†Rents Accrued for Lease of Other roads	$....	
Interest Accrued on Funded Debt	....	
Other Interest	....	
Sinking Funds Chargeable to Income	....	
Other Deductions	....	
TOTAL DEDUCTIONS FROM GROSS CORPORATE INCOME		$....
NET CORPORATE INCOME		$....
DISPOSITION OF NET CORPORATE INCOME:		
Dividends Declared:		
(a) On Preferred Stock	$....	
(b) On Common Stock	....	
(c) On Other Securities	....	
	$....	
Additions and Betterments Charged to Income	....	
Appropriations to Reserves	....	
Miscellaneous:		
(specify)	$....	
	....	
BALANCE FOR YEAR CARRIED FORWARD TO CREDIT OF PROFIT AND LOSS		$....

*If "Other Rents" shows a debit balance or "Separately Operated Properties" a loss, they are entered under "Deductions from Gross Corporate Income."

†"Rents Accrued from Lease of Roads" are entered under "Other Income."

(FORM 3)

PROFIT AND LOSS ACCOUNT

Year ended.....19...

CREDIT:

Balance,.....(beginning date).....		$.....
Balance for Year Brought Forward from Income Account....		.....
*Other Properties—Profit.....		.....
Additions for year:		
(specify)	$.....	
	.....	
	.....	.....
		$.....

DEBIT:

Deductions for Year:.....	$.....	
(specify).....	.....	
	$.....	
Dividends Declared out of Surplus:		
(a) On Preferred Stock.....	$.....	
(b) On Common Stock.....	.....	
(c) On Other Securities.....	.....	.....
		.....
Balance Credit—(ending date).....		$.....

*If "Other Properties" show a loss it is, of course, entered under "Debit."

(FORM 4)

OPERATING REVENUES

Year ended.....19...

REVENUE FROM TRANSPORTATION:		
Freight Revenue		$.....
Passenger Revenue	$.....	
Excess Baggage Revenue	.....	
Parlor and Chair Car Revenue	.....	
Mail Revenue	.....	
Express Revenue	.....	
Milk Revenue (on Passenger Trains)	.....	
Other Passenger Train Revenue	.....	
TOTAL PASSENGER SERVICE TRAIN REVENUE		.....
Switching Revenue		.....
Special Service Train Revenue		.....
Miscellaneous Transportation Revenue		.....
TOTAL REVENUE FROM TRANSPORTATION		$.....
REVENUE FROM OPERATIONS OTHER THAN TRANSPORTATION:		
Station and Train Privileges	$.....	
Parcel-Room Receipts	.....	
Storage—Freight	.....	
Storage—Baggage	.....	
Car Service	.....	
Telegraph Service	.....	
Rents of Buildings and Other Property	.....	
Miscellaneous	.....	
TOTAL REVENUE FROM OPERATIONS OTHER THAN TRANSPORTATION		.....
TOTAL OPERATING REVENUES		$.....

(FORM 5)

(STEAM RAILROAD)

OPERATING EXPENSES

Year ended.....19..

		Ratio to Gen'l Acc't (Per cent)	Ratio to Total Operating Expenses (Per cent)
MAINTENANCE OF WAY AND STRUCTURES:			
Superintendence	$		
Ballast			
Ties			
Rails			
Other Track Material			
Roadway and Track			
Removal of Snow, Sand and Ice			
Tunnels			
Bridges, Trestles, and Culverts			
Over and Under Grade Crossings			
Grade Cross'gs, Fences, Ct'le G'ds, and Signs			
Snow and Sand Fences and Snow Sheds			
Signals and Interlocking Plants			
Telegraph and Telephone Lines			
Electric Power Transmission			
Buildings, Fixtures, and Grounds			
Docks and Wharves			
Roadway Tools and Supplies			
Injuries to Persons			
Stationery and Printing			
Other Expenses			
Total of Foregoing Accounts	$		
Maintaining Joint Tracks, Yards, and Other Facilities—Dr.,			
Maintaining Joint Tracks, Yards, and Other Facilities—Cr.,			
Total—Maintenance of Way and Structures,	$		
MAINTENANCE OF EQUIPMENT:			
Superintendence	$		
Steam Locomotives—Repairs			
Steam Locomotives—Renewals			
Steam Locomotives—Depreciation			
Electric Locomotives—Repairs			
Electric Locomotives—Renewals			
Electric Locomotives—Depreciation			
Passenger-Train Cars—Repairs			
Passenger-Train Cars—Renewals			
Passenger-Train Cars—Depreciation			
Freight-Train Cars—Repairs			
Freight-Train Cars—Renewals			
Freight-Train Cars—Depreciation			
Electric Equipment of Cars—Repairs			
Electric Equipment of Cars—Renewals			
Elec. Equipm't of Cars—Depreciation			
Floating Equipment—Repairs			
Floating Equipment—Renewals			
Floating Equipment—Depreciation			
Work Equipment—Repairs			
Work Equipment—Renewals			
Work Equipment—Depreciation			
Shop Machinery and Tools			
Power Plant Equipment			
M. E. Expenses carried forward	$		

OPERATING EXPENSES—Continued

		Ratio to General Account (Per Cent.)	Ratio to Total Operating Expenses (Per Cent.)
MAINTENANCE OF EQUIPMENT—Continued :			
Brought forward	$		
Injuries to Persons			
Stationery and Printing			
Other Expenses			
Total of Foregoing Accounts,	$		
Maintaining Joint Equipment at Terminals—Dr.			
Maintaining Joint Equipment at Terminals—Cr.			
Total—Maintenance of Equipment	$		
TRAFFIC EXPENSES:	$		
Superintendence			
Outside Agencies			
Advertising			
Traffic Associations			
Fast Freight Lines			
Industrial and Immigration Bureaus			
Stationery and Printing			
Other Expenses			
Total—Traffic Expenses	$		
TRANSPORTATION EXPENSES:	$		
Superintendence			
Dispatching Trains			
Station Employees			
Weighing and Car-Service Associations			
Coal and Ore Docks			
Station Supplies and Expenses			
Yardmasters and their Clerks			
Yard Conductors and Brakemen			
Yard Switch and Signal Tenders			
Yard Supplies and Expenses			
Yard Enginemen			
Enginehouse Expenses—Yard			
Fuel for Yard Locomotives			
Water for Yard Locomotives			
Lubricants for Yard Locomotives			
Other Supplies for Yard Locomotives			
Total of Last Fifteen Accounts	$		
Operating Joint Yards and Terminals—Dr.			
Operating Joint Yards and Terminals—Cr.			
Total—Station and Yard Expenses	$		
Motormen			
Road Enginemen	$		
Enginehouse Expenses—Road			
Fuel for Road Locomotives			
Water for Road Locomotives			
Lubricants for Road Locomotives			
Other Supplies for Road Locomotives			
Transportation Expenses carried forward	$		

OPERATING EXPENSES—Continued.

		Ratio to General Expenses (Per cent)	Ratio to T'tal Operating Exp. (Per cent)
TRANSPORTATION EXPENSES—Continued:			
Brought forward	$		
Operating Power Plants			
Purchased Power			
Road Trainmen			
Train Supplies and Expenses			
Interlockers, Block and Other Signals—Operation			
Crossing Flagmen and Gatemen			
Drawbridge Operation			
Clearing Wrecks			
Telegraph and Telephone—Operation			
Operating Floating Equipment			
Express Service			
Stationery and Printing			
Other Expenses			
Loss and Damage—Freight			
Loss and Damage—Baggage			
Damage to Property			
Damage to Stock on Right of Way			
Injuries to Persons			
Total of Last Twenty-five Accounts	$		
Oper't'g Joint Tracks and Facilities—Dr.			
Oper't'g Joint Tracks and Facilities—Cr.			
Total—Movement Expenses,	$		
Total—Transportation Expenses,	$		
GENERAL EXPENSES			
Salaries and Expenses of General Officers			
Salaries and Expenses of Clerks and Attendants			
General Office Supplies and Expenses			
Law Expenses			
Insurance			
Relief Department Expenses			
Pensions			
Stationery and Printing			
Other Expenses			
Total of Foregoing Accounts,	$		
General Administration Joint Tracks, Yards, and Terminals—Dr.,			
General Administration Joint Tracks, Yards, and Terminals—Cr.,			
Total—General Expenses	$		
RECAPITULATION OF EXPENSES:			
Maintenance of Way and Structures	$		
Maintenance of Equipment			
Traffic Expenses			
Transportation Expenses			
General Expenses			
Total—Operating Expenses,	$		

Ratio of Operating Expenses to Operating Revenues,.....per cent.

(FORM 6—Concluded)

SUMMARY OF REVENUES AND EXPENSES OF OUTSIDE OPERATIONS AND OTHER PROPERTIES

Year ended.....19....

A. OUTSIDE OPERATIONS.

Designation.	Revenues	Expenses	Net Revenue or Deficit
	$	$	$
Boat Lines			
Ferry Lines			
Harbor Terminal Transfers			
Electric Railways			
Express Lines			
Cab and Omnibus Service			
Sleeping-Car Service			
Parlor and Chair-Car Service			
Dining and Special Car Service			
Electric Light and Power Plants			
Gas-Producing Plants			
Canals			
Grain Elevators			
Stock Yards			
Commercial Telegraph and Telephone Lines			
Hotels and Restaurants			
Amusement Parks and Resorts			
Coal Storage Plants			
Cold Storage Plants			
Commercial Ice Supply Plants			
Public Toll-Bridge Service			
Miscellaneous:			
Total	$	$	$

B. OTHER PROPERTIES.

Designation.	Revenues	Expenses	Taxes	Income or Loss
	$	$	$	$
Total,	$	$	$	$

(Form 7)

STANDARD SCHEDULE OF REVENUE AND EXPENSE

(Income and Expenditure)

For Municipal Industries and Public Service Corporations

REVENUE FROM OPERATING.

Gross Earnings from Public Services		$
Gross Earnings from Private Consumers		$
Gross Earnings from By-Products, etc		$
Total		$
Deduct Rebates, Refunds, Discounts, etc		$
Total Revenue from Operating		$

EXPENSE OF OPERATING

1.	Expense of Manufacture		
	Operation	$	
	Maintenance	$	
	Product Purchased (Gas, etc.)	$	
2.	Expense of Distribution		
	Operation	$	
	Maintenance	$	
3.	General Expense (Salaries, Office Supplies and Expenses)	$	
	Total (1, 2 and 3)	$	
4.	Taxes (Real Estate and Other)	$	
5.	Franchise Taxes (paid or accrued annually or otherwise)	$	
6.	Rentals (Leaseholds, etc.)	$	
7.	Insurance (Fire, Accident and Fiduciary)	$	
8.	Damages (including Extraordinary Legal and Other Expenses and Losses)	$	
9.	Guaranty (Bad Debts Written Off and Reserve for Doubtful Accounts)	$	
10.	Depreciation (Deterioration Written Off and Reserve for Estimated Depreciation)	$	
	Total Expense of Operating		$
a.	Net Revenue from Operating (or Deficiency)		$
b.	Other Revenue, or Income, net (from Sources Other Than Operating)		$
c.	Appropriations for Operating, Provided by the Municipality from General Funds		$
	Total Available Income		$

DISPOSITION OF AVAILABLE INCOME

11.	Interest on Funded and Floating Debts		$
	Remainder of Available Income		$
12.	Reserved for Sinking Funds	$	
13.	Reserved for Amortization Funds	$	
14.	Reserved for Other Funds	$	
	Total Reserves	$	
15.	Dividends (Private Plants)	$	
16.	Appropriation to General City Funds (Public Plants)	$	
	Total disposition of Available Income		$
	Credit (or Debit) balance transferable to "Surplus"		$

NOTE: The various items in this condensed statement (particularly expense items 1 2 and 3) should be supported by detailed schedules.

(Form 8)

CLASSIFICATION OF EXPENDITURES FOR ROAD AND EQUIPMENT OF ELECTRIC RAILWAYS

I. ROAD—

1. Engineering and Superintendence
2. Right of Way
3. Other Land Used in Electric Railway Operations
4. Grading
5. Ballast
6. Ties
7. Rails, Rail Fastenings, and Joints
8. Special Work
9. Underground Construction
10. Paving
11. Track Laying and Surfacing
12. Roadway Tools
13. Tunnels
14. Elevated Structures and Foundations
15. Bridges, Trestles, and Culverts
16. Crossings, Fences, Cattle Guards, and Signs
17. Interlocking and other Signal Apparatus
18. Telegraph and Telephone Lines
19. Poles and Fixtures
20. Underground Conduits
21. Transmission System
22. Distribution System
23. Dams, Canals, and Pipe Lines
24. Power-Plant Buildings
25. Substation Buildings
26. General Office Buildings
27. Shops and Carhouses
28. Stations, Waiting Rooms, and Miscellaneous Buildings
29. Docks and Wharves
30. Power-Plant Equipment
31. Substation Equipment
32. Shop Equipment
33. Park and Resort Property
34. Cost of Road Purchased

II. EQUIPMENT—

35. Cars
36. Locomotives
37. Electric Equipment of Cars
38. Other Rail Equipment
39. Miscellaneous Equipment

III. GENERAL EXPENDITURES—

40. Law Expenses
41. Interest
42. Injuries and Damages
43. Taxes
44. Miscellaneous

OPERATING REVENUES.

Year ended.....19..

REVENUE FROM TRANSPORTATION:		
Passenger Revenue	$.....	
Baggage Revenue	.....	
Parlor, Chair and Special Car Revenue	.....	
Mail Revenue	.....	
Express Revenue	.....	
Milk Revenue	.....	
Freight Revenue	.....	
Switching Revenue	.....	
Miscellaneous Transportation Revenue	.....	
TOTAL,		$.....
REVENUE FROM OPERATIONS OTHER THAN TRANSPORTATION:		
Station and Car Privileges	$.....	
Parcel-Room Receipts	.....	
Storage	.....	
Car Service	.....	
Telegraph and Telephone Service	.....	
Rents of Tracks and Terminals	.....	
Rents of Equipment	.....	
Rents of Buildings and Other Property	.....	
Power	.....	
Miscellaneous	.....	
Total,		.....
Total Operating Revenues		$.....

OPERATING EXPENSES

Year ended.....19...

		Ratio to Gen'l Acc't (Per cent)	Ratio to Total Operating Expenses (Per cent)
WAY AND STRUCTURES:			
Sup'tendence of Way and Structures	$		
Ballast			
Ties			
Rails			
Rail Fastenings and Joints			
Special Work			
Underground Construction			
Roadway and Track Labor			
Paving			
Misc. R'dway and Track Expenses			
Cleaning and Sanding Track			
Removal of Snow, Ice and Sand			
Tunnels			
Elevated Structures and Foundations			
Bridges, Trestles, and Culverts			
Cross'gs, Fences, Cattle G'ds, and Signs			
Signal and Interlocking Systems			
Telephone and Telegraph Systems			
Other Miscellaneous Way Expenses			
Poles and Fixtures			
Underground Conduits			
Transmission System			
Distribution System			
Miscellaneous Electric Line Expenses			
Buildings and Structures			
Depreciation of Way and Structures	———	———	———
Foreg'g Way and Structure Exp.	$		
Other Operations—Dr.,			
Other Operations—Cr.,	———	———	———
Total—Way and Structures,	$		
	═══	═══	═══
EQUIPMENT:			
Superintendence of Equipment			
Power-Plant Equipment			
Substation Equipment			
Passenger and Combination Cars			
Freight, Express, and Mail Cars			
Locomotives			
Service Cars			
Electric Equipment of Cars			
Electric Equipment of Locomotives			
Shop Machinery and Tools			
Shop Expenses			
Horses and Vehicles			
Other Misc. Equipment Expenses			
Depreciation of Equipment	———	———	———
Foregoing Equipment Expenses	$		
Others Operations—Dr.,			
Other Operations—Cr.,	———	———	———
Total—Equipment	$		
	═══	═══	═══
TRAFFIC:			
Superintendence and Solicitation			
Advertising			
Miscellaneous Traffic Expenses	———	———	———
Total Traffic,	$		
	═══	═══	═══

OPERATING EXPENSES—Continued

		Ratio to General Account (Per Cent)	Ratio to Total Operating Expenses (Per Cent)
CONDUCTING TRANSPORTATION:			
Superintendence of Transportation...	$		
Group I—Power			
Power-Plant Employees			
Substation Employees			
Fuel for Power			
Water for Power			
Lubricants for Power			
Miscellaneous Power-Plant Supplies and Expenses			
Substation Supplies and Expenses			
Power Purchased			
Power Exchanged—Balance,			
Foregoing Conducting Transportation Expenses	$		
Other Operations—Dr.,			
Other Operations—Cr.,			
Group II Operation of Cars			
Passenger Conductors, Motormen, and Trainmen			
Freight and Express Conductors, Motormen and Trainmen			
Miscellaneous Car-Service Employees			
Miscellaneous Car-Service Expenses			
Station Employees			
Station Expenses			
Carhouse Employees			
Carhouse Expenses			
Operation of Signal and Interlocking Systems			
Operation of Telephone and Telegraph Systems			
Express and Freight Collections and Delivery			
Loss and Damage			
Other Transportation Expenses			
Total—Conducting Transportation	$		
GENERAL AND MISCELLANEOUS:			
Salaries and Expenses of General Officers			
Salaries and Expenses of General Office Clerks			
General Office Supplies and Expenses			
Law Expenses			
Relief Department Expenses			
Pensions			
Miscellaneous General Expenses			
Foregoing General and Miscellaneous Expenses, forward	$		

OPERATING EXPENSES—Concluded

		Ratio to General Account (Per Cent)	Ratio to Total Operating Expenses (Per Cent)
General and Misc. Exp., forward			
Other Operations—Dr.,			
Other Operations—Cr.,			
Total—General and Miscellaneous	$		

UNDISTRIBUTED ACCOUNTS:

NOTE: Carriers are at liberty to distribute items covered by the following accounts, but all reports to the Commission must agree with accounts which are prescribed.

Injuries and Damages			
Insurance			
Stationery and Printing			
Store Expenses			
Stable Expenses			
Rent of Tracks and Terminals			
Rent of Equipment			
Total	$		

RECAPITULATION OF EXPENSES:

Way and Structures			
Equipment			
Traffic			
Conducting Transportation			
General and Miscellaneous			
Total Operating Expenses	$		

Ratio of Operating Expenses to Operating Revenues (per cent).....

(FORM 11—Concluded)

THE.....GAS AND ELECTRIC COMPANY

BALANCE SHEET.....19

ASSETS:

FRANCHISES AND PLANT:		
Organization		$.....
Electric: Franchises	$.....	
Land Devoted to Operations	.....	
Plant and Equipment	.....	
		.....
Gas: Franchises	$.....	
Land Devoted to Operations	.....	
Plant and Equipment	.....	
		.....
Outside Operations		.....
		$.....
INVESTMENTS:		
Funded Debt of Other Corporations	$.....	
Stocks of Other Corporations	.....	
Advances to *Subsidiary and Affiliated Corporations	.....	
Other Investments	.....	
		.....
SPECIAL DEPOSITS		.....
PREPAYMENTS		.....
SUSPENSE		.....
CURRENT ASSETS:		
Materials and Supplies, Electric	$.....	
Materials and Supplies, Gas	.....	
Bills Receivable	.....	
Accounts Receivable	.....	
Cash	.....	
Other Current Assets	.....	
		.....
		$.....

LIABILITIES:

FUNDED DEBT:		
(Specify, stating nature, rate of interest and due date)		$.....
		$.....
DUE *SUBSIDIARY AND AFFILIATED COMPANIES		.....
CURRENT LIABILITIES:		
Bills Payable	$.....	
Accounts Payable	.....	
Interest on Funded Debt	.....	
Interest on Floating Debt	.....	
Taxes	.....	
Consumers' Deposits, Electric	.....	
Consumers' Deposits, Gas	.....	
Miscellaneous	.....	
		.....
RESERVES:		
(Specify)	$.....	
.....	.....	
		.....
CAPITAL STOCK:		
(If more than one class specify)		.....
CORPORATE SURPLUS		.....
		$.....

*Or "Controlling"

(FORM 12)

(GAS AND ELECTRIC COMPANY)

INCOME ACCOUNT

YEAR ENDED.....19

OPERATING INCOME:			
ELECTRIC OPERATIONS:			
Gross Operating Revenues		$.....	
Operating Expenses	$.....		
Taxes	.....		
Uncollectible Bills	.....	.....	
Income from Electric Operations			$.....
GAS OPERATIONS:			
Gross Operating Revenues		$.....	
Operating Expenses	$.....		
Taxes	.....		
Uncollectible Bills	.....	.....	
Income from Gas Operations			.....
OUTSIDE OPERATIONS:			
Gross Revenues from Outside Operations		$.....	
Operating Expenses	$.....		
Taxes	.....		
Uncollectible Bills	.....	.....	
Income from Outside Operations			.....
Total Operating Income			$.....
NON-OPERATING INCOME:			
Other Rents—Credits		$.....	
Interest Accrued on Bonds Owned or Controlled		.....	
Interest on Other Securities, Loans and Accounts		.....	
Dividends on Stocks Owned or Controlled		.....	
*Separately Operated Properties—Profit		.....	
Miscellaneous Income		.....	
Total Non-Operating Income			$.....
Gross Income Applicable to Corporate and Leased Properties			$.....
DEDUCTIONS FROM GROSS INCOME:			
Interest accrued on Funded Debt and Debenture Stocks		$.....	
Other Interest Deductions		.....	
†Rents Accrued for Lease of Other Electric Plant or Equipment		.....	
†Rents Accrued for Lease of Other Gas Plant or Equipment		.....	
Other Rents Accrued—Debits		.....	
Sinking Funds Chargeable to Income		.....	
Guaranties of Periodic Payments		.....	
Other Contractual Deductions		.....	
Amortization Chargeable to Income		.....	
Total Deductions from Gross Income			.....
Net Corporate Income Transferred to Credit of Corporate Surplus			$.....

*Loss on separately operated properties would be entered under "Deductions from Gross Income."

†Rents accrued from plant or equipment leased would be entered under "Non-operating Income."

(FORM 13)

CORPORATE SURPLUS ACCOUNT

CREDITS:

Balance.....(beginning date).....		$.....
Balance transferred from Income Account		.....
Bad Debts Collected.....		.....
Other Additions to Surplus:		
(Specify).....		.....
		$.....

DEBITS:

Dividends Declared:		
On Preferred Stock.	$.....	
On Common Stock.....	.....	
On Other Securities.....	.....	
	$.....	
Expenses elsewhere unprovided for.....	.....	
Amortization elsewhere unprovided for.....	.....	
Appropriations to Reserves.....	.....	
Gifts to Controlled Corporations.....	.....	
Other Appropriations.....	.....	
Bad Debts written off.....	.....	
Other Deductions from Surplus:		
(Specify).....	.....	.....
Balance.....(closing date).....		$.....

(Form 14)

LIST OF ACCOUNTS

PRESCRIBED BY NEW YORK PUBLIC SERVICE COMMISSION

(2ND DISTRICT)

FOR

ELECTRIC LIGHT, HEAT AND POWER COMPANIES

(Effective 1st January, 1909)

SCHEDULE A: BALANCE SHEET OR INDICANT ACCOUNTS.

FIXED CAPITAL:

Fixed Capital, December 31, 1908
Land Devoted to Electric Operations
Organization
Franchises (Electric)
Patent-rights (Electric)
Other Intangible Electric Capital
General Structures
General Equipment
Dams, Canals, and Pipe Lines
Power Plant Buildings
Furnaces, Boilers, and Accessories
Steam Engines
Turbines and Water-wheels
Gas Producers and Accessories
Gas Engines
Electric Generators
Accessory Electric Power Equipment
Miscellaneous Power Plant Equipment
Substation Buildings
Substation Equipment
Poles and Fixtures
Underground Conduits
Transmission System
Distribution System
Line Transformers and Devices
Electric Services
Electric Meters
Electric Meter Installation
Municipal Street Lighting System (Electric)
Commercial Arc Lamps
Glower Lamps
Electric Motors and Heaters
Electric Tools and Implements
Electric Laboratory Equipment
Other Tangible Electric Capital
Engineering and Superintendence
Law Expenditures During Construction
Injuries During Construction
Taxes During Construction
Miscellaneous Construction Expenditures
Interest During Construction
Land in other Departments
Franchises in Other Departments
Patent-rights in Other Departments
Other Intangible Capital in Other Departments
Tangible Capital in Other Departments

FLOATING CAPITAL:
- Materials and Supplies
- Cash
- Bills Receivable
- Accounts Receivable
- Interest and Dividends Receivable
- Other Current Assets

INVESTMENTS:
- *Investments

SPECIAL DEPOSITS:
- Coupon Special Deposits
- Dividend Special Deposits
- Other Special Deposits

PREPAYMENT ACCOUNTS:
- Prepaid Taxes
- Prepaid Insurance
- Prepaid Rents
- Other Prepayments

SUSPENSE ACCOUNTS:
- Unamortized Debt Discount and Expense
- Other Suspense

RE-ACQUIRED SECURITIES:
- Re-acquired Securities

DEBT:
- Funded (Separate sub-account for each class)
- Unfunded:
  - Taxes Accrued
  - Receiver's Certificates
  - Judgments Unpaid
  - Interest Accrued
  - Dividends Declared
  - Bills Payable
  - Consumers' Deposits—Electric
  - Other Accounts Payable
  - Other Unfunded Debt

RESERVES:
- Permanent
  - Premiums on Stock
  - Other Permanent Reserves

*Defined as "all properties acquired not for use in present operations, but as a means of obtaining or exercising control over other corporations, or for income to be derived therefrom, or for a rise in value, or for devotion to future operations at a time when it seems probable that they cannot be so advantageously acquired as at the time of actual acquisition."

ACCOUNTS FOR ELECTRIC COMPANIES.—Continued

RESERVES—Continued:
- Temporary:
  - Contractual
  - Non-contractual
- Required:
  - Accrued Amortization of Capital
  - Unamortized Premium on Debt
  - Other Required Reserves
- Optional:
  - Casualties and Insurance Reserve
  - Other Optional Reserves

STOCKS:
- Stocks (separate sub-account for each class)

SCHEDULE B: INCOME ACCOUNT.

OPERATING REVENUES:
- Municipal Street Lighting—Arc
- Municipal Street Lighting—Incandescent
- Lighting Municipal Buildings—Electric
- Municipal Heat and Power—Electric
- Miscellaneous Electric Revenue—Municipal
- Commercial Flat Rate Lighting
- Commercial Flat Rate Power
- Commercial Metered Lighting
- Commercial Metered Power
- Railroad Corporations
- Other Electrical Corporations
- Rent of Electric Meters
- Rent of Electric Appliances
- Electric Merchandise and Jobbing Revenue
- Sale of By-Products
- Joint Electric Rent Revenue
- Break-down Service
- Other Miscellaneous Electric Revenue

OPERATING EXPENSES.

I. PRODUCTION EXPENSES:
- Station Superintendence and Care
- Boiler Labor
- Producer Labor
- Engine Labor
- Electric Labor
- Fuel for Steam
- Fuel for Producer Gas
- Water for Steam Power and Gas
- Water for Hydraulic Power
- Lubricants for Power
- Production Supplies
- Station Expense
- Repairs of Power Plant Buildings
- Repairs of Furnaces and Boilers
- Repairs of Boiler Apparatus

Repairs of Steam Accessories
Repairs of Reciprocating Engines
Repairs of Steam Turbines
Repairs of Other Steam Engine Equipment
Repairs of Dams, Canals, and Pipe Lines
Repairs of Turbines and Water-wheels
Repairs of Gas Producers and Accessories
Repairs of Gas Engines
Repairs of Electric Generators
Repairs of Accessory Electric Equipment
Repairs of Station Tools and Implements
Repairs of Miscellaneous Station Equipment
Steam from Other Sources
Power Gas from Other Sources
Electric Energy from Other Sources

II. TRANSMISSION EXPENSES:
Transmission Subway Rent
Transmission Pole and Fixture Repairs
Transmission Underground Conduit Repairs
Overhead Transmission System Repairs
Underground Transmission System Repairs
Substation Labor
Substation Supplies and Expenses
Repairs of Substation Buildings
Repairs of Substation Equipment

III. ELECTRIC STORAGE EXPENSES:
Storage Battery Labor
Storage Battery Supplies
Storage Battery Renewals
Repairs of Storage Battery Accessories

IV. DISTRIBUTION EXPENSES:
Electric Distribution Superintendence
Electric Distribution Maps and Records
Electric Distribution Office Expense
Setting and Removing Meters and Transformers
Distribution Subway Rent
Distribution Pole and Fixture Repairs
Distribution Underground Conduit Repairs
Overhead Distribution System Repairs
Edison Tube System Repairs
Other Underground Distribution System Repairs
Repairs of Electric Services
Repairs of Transformers
Electric Meter Operation
Electric Meter Repairs

V. UTILIZATION EXPENSES:
Commercial Arc Labor
Commercial Arc Supplies
Commercial Arc Repairs
Commercial Incandescent Installation
Commercial Incandescent Renewals
Inspection of Consumers' Premises
Repairs of Consumers' Installations
Municipal Street Arc Labor
Municipal Street Arc Supplies
Municipal Street Arc Repairs
Municipal Street Incandescent Installation
Municipal Street Incandescent Renewals
Municipal Street Incandescent Repairs

VI. COMMERCIAL EXPENSES:
Commercial Administration—Electric
Promotion Office Expense—Electric
Advertising—Electric
Canvassing and Soliciting—Electric
Promotion Wiring and Devices

VII. GENERAL AND MISCELLANEOUS EXPENSES:
Salaries and Expenses of General Officers
Salaries and Expenses of General Office Clerks
General Office Supplies and Expenses
General Law Expenses
Miscellaneous General Expenses
Insurance
Relief Department Expenses
Pensions
Electric Franchise Requirements
General Amortization—Electric
Electric Expenses Transferred—Cr.
Joint Operating Expense—Cr.
Accidents and Damages
Law Expenses Connected with Damages
General Stationery and Printing
Store Expenses
Stable Expenses
Undistributed Adjustments—Balance
Duplicate Electric Charges—Cr.

TAXES:
Taxes
Uncollectible Electric Bills

Non-Operating Revenues:
- Rent Accrued from Lease of Electric Plant
- Miscellaneous Rent Revenues
- Interest Revenues
- Dividend Revenues
- Profits from Operations of Others
- Miscellaneous Non-operating Revenues

Non-Operating Revenue Deductions:
- a. Rent Expense
- b. Interest Expense
- c. Dividend Expense
- d. Others' Operations Expense
- e. Miscellaneous Non-Operating Expense
- f. Non-Operating Taxes
- g. Uncollectible Non-operating Revenues

Income Deductions:
- Interest Deductions
- Rent for Lease of Other Electric Plant
- Joint Facility Rents
- Miscellaneous Rent Deductions
- Sinking Fund Accruals
- Guaranties of Periodic Payments
- Loss on Operations of Others
- Other Contractual Deductions from Income
- Amortization of Landed Capital
- Amortization of Debt, Discount and Expense
- Amortization of Premium on Debt—Cr.

Appropriation Accounts:
- Bad Debts Collected
- Other Additions to Surplus
- Expenses Elsewhere Unprovided for
- Dividends on Outstanding Stocks
- Amortization Elsewhere Unprovided for
- Appropriations to Reserves
- Gifts to Controlled Corporations
- Other Appropriations
- Bad Debts Written Off
- Other Deductions from Surplus

(Form 15—Concluded)

LIST OF ACCOUNTS

PRESCRIBED BY NEW YORK PUBLIC SERVICE COMMISSION (2ND DISTRICT)

FOR

GAS COMPANIES

(Effective 1st January, 1909)

SCHEDULE A: BALANCE SHEET OR INDICANT ACCOUNTS

FIXED CAPITAL:

Fixed Capital, December 31, 1908
Land Devoted to Gas Operations
Organization
Franchises (Gas)
Patent-rights (Gas)
Other Intangible Gas Capital
General Structures
General Equipment
Works and Station Structures
Holders
Furnaces, Boilers, and Accessories
Steam Engines
Gas Engines
Miscellaneous Power Plant Equipment
Benches and Retorts
Water Gas Sets and Accessories
Purification Apparatus
Accessory Equipment at Works
Trunk Lines and Mains
Gas Services
Gas Meters
Gas Meter Installation
Municipal Street Lighting Fixtures (Gas)
Gas Engines and Appliances
Gas Tools and Implements
Gas Laboratory Equipment
Other Tangible Gas Capital
Engineering and Superintendence
Law Expenditures During Construction
Injuries During Construction
Taxes During Construction
Miscellaneous Construction Expenditures
Interest During Construction
Land in Other Departments
Franchises in Other Departments
Patent-rights in Other Departments
Other Intangible Capital in Other Departments
Tangible Capital in Other Departments

FLOATING CAPITAL:

Materials and Supplies
Cash
Bills Receivable
Accounts Receivable
Interest and Dividends Receivable
Other Current Assets

(FORM 16)

INVESTMENTS:
- Investments

SPECIAL DEPOSITS:
- Coupon Special Deposits
- Dividend Special Deposits
- Other Special Deposits

PREPAYMENTS:
- Prepaid Taxes
- Prepaid Insurance
- Prepaid Rents
- Other Prepayments

SUSPENSE ACCOUNTS:
- Unamortized Debt Discount and Expense
- Other Suspense

RE-ACQUIRED SECURITIES:
- Re-acquired Securities

DEBT:
- Funded (separate sub-account for each class)
- Unfunded:
  - Taxes Accrued
  - Receiver's Certificates
  - Judgments Unpaid
  - Interest Accrued
  - Dividends Declared
  - Bills Payable
  - Consumers' Deposits—Gas
  - Other Accounts Payable
  - Other Unfunded Debt

RESERVES:
- Permanent:
  - Premiums on Stocks
  - Other Permanent Reserves
- Temporary:
  - Contractual
  - Non-contractual
- Required:
  - Accrued Amortization of Capital
  - Unamortized Premium on Debt
  - Other Required Reserves
- Optional:
  - Casualties and Insurance Reserve
  - Other Optional Reserves

STOCKS:
- Stocks (separate sub-account for each class)

(FORM 16—Continued)

SCHEDULE B: INCOME ACCOUNT

OPERATING REVENUES:

Municipal Street Lighting—Gas
Lighting Municipal Buildings—Gas
Municipal Heat and Power—Gas
Miscellaneous Gas Revenue—Municipal
Prepaid Gas
Commercial Metered Lighting—Gas
Commercial Heat and Power—Gas
Other Gas Corporations
Commissions on Others' Gas
Rent of Gas Appliances
Gas, Merchandise, and Jobbing Revenue
Sale of Residuals and By-Products
Joint Gas Rent Revenue
Other Miscellaneous Gas Revenue

OPERATING EXPENSES:

I. PRODUCTION EXPENSES:

Works Superintendence
Boiler House Labor
Retort House Labor
Generator House Labor
Purifier House Labor
Miscellaneous Labor at Works
Boiler Fuel
Water
Fuel Under Retorts
Coal Carbonized
Coal Gas Enric er
Generator Fuel
Water Gas Oil
Purification Supplies
Miscellaneous Works Expense
Repairs of Works and Station Structures
Repairs of Furnaces, Boilers, and Accessories
Repairs of Steam Engines
Repairs of Gas Engines
Repairs of Miscellaneous Power Plant Equipment
Repairs of Benches and Retorts
Repairs of Water Gas Sets and Accessories
Repairs of Purification Apparatus
Repairs of Holders
Repairs of Miscellaneous Equipment
Repairs of Works Tools
Gas Storage
Gas from Other Sources

II. TRANSMISSION AND DISTRIBUTION EXPENSES:

Transmission Pumping
Distribution Superintendence
Distribution Supplies and Expenses
Gas Meter and Installation Work

Work on Consumers' Premises
Repairs of Gas Mains
Repairs of Gas Services
Repairs of Gas Meters
Repairs of Distribution Tools
Repairs of Gas Appliances

III. MUNICIPAL STREET LIGHTING EXPENSES:
Street Lamp Operating
Street Lamp Repairs

IV. COMMERCIAL EXPENSES:
Commercial Administration—Gas
Promotion Office Expenses—Gas
Advertising—Gas
Canvassing and Soliciting—Gas

V. GENERAL AND MISCELLANEOUS EXPENSES:
Salaries of General Officers
Salaries of General Office Clerks
General Office Supplies and Incidental Expenses
General Law Expenses
Miscellaneous General Expenses
Insurance
Relief Department Expenses
Pensions
Gas Franchise Requirements
Residuals Expense
General Amortization—Gas
Gas Expenses Transferred—Cr.
Joint Operating Expense
Accidents and Damages
Law Expenses Connected with Damages
General Stationery and Printing
Store Expenses
Stable Expenses
Undistributed Adjustments—Balance
Duplicate Gas Charges—Cr.

TAXES:
Taxes
Uncollectible Gas Bills

NON-OPERATING REVENUES:
Rent Accrued from Lease of Gas Plant
Miscellaneous Rent Revenues
Interest Revenues
Dividend Revenues
Profits from Operations of Others
Miscellaneous Non-Operating Revenues

Non-Operating Revenue Deductions:

a. Rent Expense
b. Interest Expense
c. Dividend Expense
d. Others' Operations Expense
e. Miscellaneous Non-Operating Expense
f. Non-Operating Taxes
g. Uncollectible Non-operating Revenues

Income Deductions:

Interest Deductions
Rent for Lease of Other Gas Plant
Other Rent Deductions
f. Joint Facility Rents
g. Miscellaneous Rent Deductions
Sinking Fund Accruals
Guaranties of Periodic Payments
Loss on Operations of Others
Other Contractual Deductions from Income
Amortization of Landed Capital
Amortization of Debt Discount and Expense
Amortization of Premium on Debt—Cr.

Appropriation Accounts:

Bad Debts Collected
Other Additions to Surplus
Expenses Elsewhere Unprovided for
Dividends on Outstanding Stocks
Amortization Elsewhere Unprovided for
Appropriations to Reserves
Gifts to Controlled Corporations
Other Appropriations
Bad Debts Written Off
Other Deductions from Surplus

(Form 16—Concluded)

TENTATIVE CLASSIFICATION OF THE OPERATION ACCOUNTS OF WATER SUPPLY ENTERPRISES.

INCOME ACCOUNTS.

GROSS INCOME FROM OPERATION.

I. Income From Water Service.

A. Pay Rates for Private Consumers Within City
1. Metered Domestic Rates
2. Metered Manufacturing and Commercial Rates
3. Unmetered Domestic Rates
4. Unmetered Manufacturing and Commercial Rates

B. Pay Rates for Private Consumers Outside City
5. Metered Domestic Rates
6. Metered Manufacturing and Commercial Rates
7. Unmetered Domestic Rates
8. Unmetered Manufacturing and Commercial Rates

C Pay Rates for Other Waterworks
9. Rates for Other City and Private Water Enterprises

D. Fees for Shutting off and Turning on Water
10. Fees for Shutting off and Turning on Water

E. Pay Rates for City
11. Fire Department
12. Sewer Flushing
13. Street Sprinkling and Washing
14. Public Schools
15. All Other Public Buildings
16. Public Parks, Fountains, and Troughs
17. All Other Municipal Purposes

F. Free Rates for City
18. Fire Department
19. Sewer Flushing
20. Street Sprinkling and Washing
21. Public Schools
22. All Other Public Buildings
23. Public Parks, Fountains and Troughs
24. All Other Municipal Purposes

G. Free Rates for Private Consumers
25. Water for Churches, Private Charities, etc.

H. Value of Water Used by Water-Supply System
26. For Purification Purposes
27. For Pumping Purposes
28. For Plant and Other Private Fire Protection
29. For all Other Uses and Purposes

II. Income Other Than From Water Service

I. Income from Accessory Enterprises
30. Income from Plumbing Work for Compensation
31. Rents from Rental Property
32. Rents from Meters, Meter Boxes, and Vaults
33. Income from Stables, Teams, and Teamsters
34. Income from Forest Lands
35. Income from Other Accessory Enterprises

J. Earnings of Invested Funds
36. Earnings of Sinking Funds
37. Earnings of Depreciation Funds
38. Earnings of Other Reserve Funds

(WATER SUPPLY ENTERPRISES)

INCOME ACCOUNTS—Continued

K. Interest on Cash Balances in Bank:

39. Interest to Credit of Enterprise
40. Interest to Credit of City

L. Income from Miscellaneous Sources:

41. Sundry Rents
42. Sundry Services
43. Sundry Objects
44. Permits
45. Gains from Bond Transactions
46. Other Gains

Income Clearing Accounts:

Income from Water Service
Income from Accessory Enterprises
Earnings from Invested Funds
Income from Miscellaneous Sources

EXPENSE ACCOUNTS

TOTAL EXPENSES OF OPERATIONS

GROUP 1. EXPENSES OF WATER SERVICE

III. Expenses of General Management

M. General Administrative Expenses

Division 1.—Expenses Payable to Public

100. Salaries and Expenses of General Administrative Officers and Employees
101. Rent of Offices, etc.
102. Other General Administrative Office Expenses
103. Stationery, Printing, and Advertising
104. Law Expenses
105. Sundry General Administrative Expenses

Division 2.—Expenses Payable to City

106. Rent of City Offices for Administrative Purposes

N. Accounting Expenses:

Division 1.—Expenses Payable to Public

107. Salaries and Expenses of Accounting Officers and Employees
108. Rent of Offices, etc
109. Other Accounting Office Expenses
110. Stationery, Printing and Advertising
111. Sundry Accounting Expenses

Division 2.—Expenses Payable to City

112. Proportion of Salaries and Expenses of Accounting Officers and Employees of City
113. Rent of City Offices for Accounting Purposes

O. Operating Management Expenses:

Division 1.—Expenses Payable to Public

114. Salaries and Expenses of Operating Management Officers
115. Laboratory Salaries and Expenses
116. Salaries and Expenses of Other Operating Management Employees
117. Rent of Offices
118. Other Office Expenses of Operating Management

(Form 17—Continued)

EXPENSE ACCOUNTS—CONTINUED

O. *Operating Management Expenses,*—Continued

Division 1.—Expenses Payable to Public

119. Rents and Expenses of Shops, Storerooms, etc.
120. Stationery and Printing
121. Advertising and Soliciting
122. Law Expenses

Division 2.—Expenses Payable to City

123. Proportion of Salaries and Expenses of Operating Management Officers and Employees of City
124. Rent of City Offices for Operating Management
125. Rent of City Buildings for Shops, Storerooms, etc.
126. Proportion of Law Expenses of City

IV. EXPENSES FOR COLLECTING AND SUPPLYING WATER

P. *Expenses for Care of Sources of Supply*

Division 1.—Surface supply

127. Drainage area and reservations
128. Impounding Dams and Reservoirs
129. Lake and River Cribs

Division 2.—Ground Supply

130. Springs and Wells
131. Infiltration Galleries and Tunnels
132. Collecting Conduits and Reservoirs

Q. *Expenses for Care of Intakes and Aqueducts:*

133. Gravity Intakes and Suction Mains
134. Aqueducts and Supply Mains

R. *Expenses for Purification of Water:*

135. By Sedimentation
136. By Coagulation
137. By Softening
138. By Slow Sand Filtration
139. By Mechanical Filtration
140. By Other Methods

S. *Expenses for Pumpipg Water:*

141. Salaries and Wages
142. Fuel (Coal, Wood, Gas, Oil, etc.)
143. Oils and Waste
144. Supplies
145. Waterpower
146. Electric Power
147. Other Power
148. All Other Pumping Expenses
149. Proportion of Steam or Other Power Plant Expenses

T. *Expenses for Transmission and Distribution Storage of Water:*

150. Force Mains
151. Reservoirs and Fire Cisterns
152. Tanks and Standpipes

U. *Expenses for Distribution of Water:*

153. Main Pipes and Specials
154. Main Valves and Valve Boxes
155. Fire Hydrants
156. Other Main Pipe Appliances
157. Service Pipes and Stops Owned by Enterprises
158. Meters and Meter Boxes and Vaults Furnished Rent Free
159. Fountains and Troughs
160. All Other

(FORM 17—Continued)

EXPENSE ACCOUNTS—CONTINUED

V. EXPENSES FOR WATER SERVICE REPAIRS

MM. General Administrative Repairs:

161. Repairs of General Administrative Buildings and Equipment

NN. Accounting Repairs

162. Repairs of Accounting Equipment
163. Repairs of Operating Management Buildings and Equipment

OO. Operating Management Repairs:

PP. Repairs at Sources of Supply:

Division 1.—Surface Supply

164. Drainage area and reservations
165. Impounding Dams and Reservoirs
166. Lake and River Cribs

Division 2.—Ground Supply

167. Springs and Wells
168. Infiltration Galleries and Tunnels
169. Aqueducts and Supply Mains

QQ. Repairs of Intakes and Aqueducts:

170. Gravity Intakes and Suction Mains
171. Aqueducts and Supply Mains

RR. Repairs of Purification System:

172. Buildings
173. Settling Basins
174. Coagulating Basins
175. Softening Equipment
176. Slow Sand Filters
177. Mechanical Filters
178. Other Purification Equipment

SS. Repairs of Pumping System:

179. Buildings
180. Boilers
181. Steam Piping and Equipment
182. Steam and Power Pumping Machinery
183. Waterpower Equipment
184. Electric Power Equipment
185. Other Power Equipment
186. Other Station Equipment
187. Proportion of Repairs of Steam and Other Power Plant and Equipment

TT. Repairs of Transmission and Distribution Storage System:

188. Force Mains
189. Reservoirs and Fire Cisterns
190. Tanks and Standpipes

UU. Repairs of Distribution System:

191. Main Pipes and Specials
192. Main Valves and Valve Boxes
193. Fire Hydrants
194. Other Main Pipe Appliances
195. Services Pipes and Stops Owned by Enterprise
196. Meters and Meter Boxes and Vaults Furnished Rent Free
197. Fountains and Troughs
198. All Other

(FORM 17—Continued)

EXPENSE ACCOUNTS—CONTINUED

VI. EXPENSES FOR WATER SERVICE INSURANCE

199. On General Administration Buildings and Equipment.
200. On Accounting Equipment.
201. On Operating Management Buildings and Equipment
202. On source of supply buildings and equipment
203. On Intake and Aqueduct Buildings and Equipment
204. On Purification System Buildings and Equipment
205. On Pumping System Buildings and Equipment.
206. On Transmission and Distribution Storage System Buildings and Equipment
207. On Distribution System Buildings and Equipment.

VII. EXPENSES FOR WATER SERVICE DEPRECIATION

208. On General Administration Buildings and Equipment
209. On Accounting Equipment
210. On operating management buildings and equipment.
211. On Sources of Supply
212. On Intakes and aqueducts
213. On Purification System.
214. On Pumping System
215. On Transmission and Distribution Storage System
216. On Distribution System

GROUP 2. EXPENSES OTHER THAN FOR WATER SERVICE

VIII. MISCELLANEOUS EXPENSES

V. Expenses of Accessory Enterprises:

217. Plumbing Work for Compensation
(a) General (b) Repairs (c) Insurance (d) Depreciation
218. Rental Property
(a) General (b) Repairs (c) Insurance (d) Depreciation
219. Meters and Meter Boxes and Vaults Rented to Consumers
(a) General (b) Repairs (c) Insurance (d) Depreciation
220. Stables, Teams and Teamsters.
(a) General (b) Repairs (c) Insurance (d) Depreciation
221. Forest Lands
(a) General (b) Repairs (c) Insurance (d) Depreciation
222. Other Accessory Enterprises
(a) General (b) Repairs (c) Insurance (d) Depreciation

W. Expenses of Invested Funds:

223. Expenses of Sinking Funds
224. Expenses of Depreciation Funds
225. Expenses of Other Reserve Funds

X. Sundry Expenses:

226. Sundry Services and Objects
227. Gratuitous Work
228. Losses on Bond Transactions
229. Other Losses

IX. FIRST CHARGES FOR WATER AND TAXES

Y. Cost of Water:

230. Annual Payments for Water Rights
231. Annual Dues to Other Water-Supply Systems
232. Amortization of expiring Term Water Rights

EXPENSE ACCOUNTS—Continued

Z. Taxes and Franchise Dues:

Division 1. Taxes and Dues Actually Paid or Payable by Enterprise

233. Real and Personal Taxes
234. Taxes on Capital Stock
235. Taxes on Earnings or Receipts
236. Other Taxes
237. Franchise dues
238. Amortization of Expiring Term Franchises

Division 2. Taxes and Dues Chargeable against Municipally Operated Enterprises by Operating City, other than those actually paid or payable

239. Real and Personal Taxes
240. Taxes on Eearnings or Receipts
241. Other Taxes
242. Franchise Dues
243. Amortization of Expiring Term Franchises

Expense Clearing Accounts:

Franchise Dues
Fuel
Injuries to Persons
Law Expenses
Oil
Stables, Teams, and Teamsters
Supplies
Taxes
Waste
Work Equipment

(Form 17—Concluded)

TENTATIVE CLASSIFICATION OF THE ALLOCATION ACCOUNTS OF WATER-SUPPLY ENTERPRISES

X. Interest Paid and Payable

300. Interest on Funded and Fixed Debts
301. Interest on Real Estate Mortgages
302. Interest on Current Liabilities

XI. Dividends and Assessments

303. Dividends on Preferred Stock
304. Dividends on Common Stock
305. Apportionment to individuals and Firm Members.
306. Profit and Loss Assessments
307. City Profit and Loss Allocation

XII. Sundry Allocation

308. Sinking Fund Appropriation
309. Depreciation Fund Allocation
310. Other Reserve Fund Allocation
311. Capital Account Transfers

Supplemental Allocation Account:

Current Transactions with City

(Form 18)

TENTATIVE CLASSIFICATION OF THE PROPERTY ACCOUNTS OR ACCOUNTS WITH COST AND PRESENT VALUE OF WATER-SUPPLY ENTERPRISES

DIVISION 1. COST AND VALUE OF OPERATING WORKS AND PROPERTY

XX. Value as a Going Concern

A. Preliminary Expenditures:

400. Engineering Expenses
401. Law Expenses
402. Injuries to Persons and Property
403. Insurance
404. Interest and Commissions
405. Taxes
406. Other Expenditures
407. Cost of Charter

B. Franchise

408. Operating Franchises and Easements

XXI. Value of Land, Buildings, and Equipments

C. Land and Equipment for Administrative Offices:

409. Land and Equipment for Administrative Offices.

D. Equipment for Accounting Offices:

410. Equipment for Accounting Offices

E. Land, Buildings, and Equipment for Operating Management:

411. Operating Management Offices
(a) Land (b) Buildings (c) Fixtures and Equipment
412. Laboratory
(a) Land (b) Buildings (c) Fixtures and Equipment
413. Shops of Operating Management
(a) Land (b) Buildings (c) Fixtures and Equipment
414. Other General Equipment
(a) Land (b) Buildings (c) Fixtures and Equipment

XXII. Value of Land, Buildings, and Equipment for Water Service

F. Land, Buildings, and Equipment at Sources of Supply:

415. Reservations
(a) Land (b) Buildings (c) Equipment
416. Impounding Dams and Reservoirs
(a) Land (b) Dams (c) Reservoirs (d) Buildings
(e) Equipment
417. Lake and River Cribs
(a) Land (b) Cribs (c) Buildings (d) Equipment
418. Springs and Wells
(a) Land (b) Springs (c) Wells (d) Buildings (e) Equipment
419. Infiltration Galleries and Tunnels
(a) Land and Right of Way (b) Galleries (c) Tunnels
(d) Buildings (e) Equipment
420. Collecting Conduits and Reservoirs
(a) Land and Right of Way (b) Conduits (c) Reservoirs
(d) Buildings (e) Equipment

G. Land, Buildings, and Equipment for Intakes and Aqueducts:

421. Gravity Intakes and Suction Mains
(a) Land and Right of Way (b) Gravity Intakes (c) Suction mains (d) Suction Wells (e) Buildings (f) Equipment

G. Land, Buildings, and Equipment for Intakes and Aqueducts,—Continued
422. Aqueducts and Supply Mains
(a) Land and right of way (b) Aqueducts (c) Supply Mains (d) Wet Wells (e) Buildings (f) Equipment

H. Land, Buildings and Equipment for Purification Works:
423. Settling Basins
(a) Land (b) Basins (c) Buildings (d) Equipment
424. Coagulating Basins
(a) Land (b) Basins (c) Buildings (d) Equipment
425. Softening Plant
(a) Land (b) Buildings (c) General Plant (d) Minor Equipment
426. Slow Sand Filters
(a) Land (b) Filters (c) Buildings (d) Equipment
427. Mechanical Filters
(a) Land (b) Buildings (c) Filters (d) Equipment
428. Other Purification Equipment
(a) Land (b) Buildings (c) General Plant (d) Minor Equipment

I. Land, Buildings, and Equipment for Pumping:
429. Pumping Stations
(a) Land (b) Buildings
430. Pumping Plant
(a) Steam and Power Pumps (b) Other Pumping Equipment
431. Steam Plant
(a) Boilers with Settings, Stacks, etc.
(b) Engines (c) Steam Piping, Condensers, etc.
(d) Other Steam Plant Equipment
432. Waterpower Plant
(a) Land (b) Dams (c) Canals (d) Buildings
(e) Other Structures (f) Water Wheels and Connections
(g) Other Equipment
433. Electric Power Equipment
(a) Motors and Dynamos
(b) Switchboards and Apparatus (c) Minor Equipment
434. Gas and Other Power Equipment
(a) Producers and Engines (b) Gas and Oil Engine Equipment
(c) Other Equipment
435. Other Station Equipment
(a) Oil and waste Apparatus (b) Station Repair Shop Equipment (c) Other Equipment
436. Proportion of Value of Steam and Other Power Plant and Equipment

J. Land, Buildings, and Equipment for Transmission and Distribution Storage System
437. Force Mains
(a) Land and Right of Way (b) Mains and Specials
(c) Valves and Valve Boxes (d) Other Appliances
(e) Buildings and Other Structures
438. Reservoirs and Fire Cisterns
(a) Land (b) Reservoirs (c) Cisterns
(d) Buildings (e) Equipment
439. Tanks and Standpipes
(a) Land (b) Tanks (c) Standpipes (d) Buildings
(e) Equipment

K. Land, Buildings, and Equipment for Distribution System
440. Land and Right of Way
441. Main Pipes and Specials
442. Main Valves and Valve Boxes
(a) Valves (b) Boxes
443. Fire Hydrants

(Form 19—Continued)

K. Land, Buildings, and Equipment for Distribution System.—Continued
- 444. Other Main Pipe Appliances
  - (a) Regulators, Air Chambers, Relief Valves, etc.
  - (b) Blow-off Cocks, etc.
- 445. Service Pipes and Stops Owned by Enterprise
- 446. Meters and meter Boxes and Vaults Furnished Rent Free
  - (a) Meters and Connections (b) Meter Boxes and Vaults
- 447. Fountains and Troughs
- 448. All Other

XXIII. Value of General Tools and Accessories Other than for General Shop Use, etc.

L. Tools and Accessories:
- 449. All General Tools
- 450. All General Apparatus and Equipment
- 451. All general Accessories

XXIV. Value of Water Rights

M. Water Rights:
- 452. Water Rights Owned in Perpetuity
- 453. Terminable Water Rights

DIVISION II.—VALUE OF ACCESSORY PROPERTY

XXV. Value of Accessory Property

N. Land, Buildings and Equipment for Miscellaneous Purposes
- 454. Offices, Shops, Storerooms, etc.
  - (a) Land (b) Buildings
- 455. Rental Property
  - (a) Land (b) Buildings
- 456. Meters and Meter Boxes and Vaults, Rented to Consumers
  - (a) Meters and Connections (b) Meter Boxes and vaults
- 457. Stables and teams
  - (a) Land (b) Buildings (c) Equipment for Stables
  - (d) Live Stock (e) Wagons (f) Harness and Team Equipment

Grand Total Value of All Physical and Intangible Property of Enterprise

(Form 19—Concluded)

CONDENSED ANALYTICAL COST ACCOUNTING SUMMARY

TRANSACTIONS	AMOUNTS			
	Total	per capita supplied	Per 1,000,000 gallons supplied to pipes	Per mile of equivalent 4-inch distribution pipe
1. Income from Domestic rates	$.....	$.....	$.....	$.....
2. Income from Mfg. and Commercial Rates	.....	.....	.....	.....
3. Income from Water Service for City	.....	.....	.....	.....
4. Value of Water Consumed by Enterprise	.....	.....	.....	.....
5. Other Income from Water Service	.....	.....	.....	.....
6. Gross Income from Water Service	.....	.....	.....	.....
7. Income other than from Water Service	.....	.....	.....	.....
8. Gross Income from Op.	.....	.....	.....	.....
9. Expenses of General Management	.....	.....	.....	.....
10. Expenses for Collecting and Supplying Water	.....	.....	.....	.....
11. Expenses for Repairs	.....	.....	.....	.....
12. Expenses for Insurance	.....	.....	.....	.....
13. Exp. for Depreciation	.....	.....	.....	.....
14. Miscellaneous Expenses	.....	.....	.....	.....
15. First Charges	.....	.....	.....	.....
16. Total Operating Expenses	.....	.....	.....	.....
17. All General Expenses	.....	.....	.....	.....
18. All Expenses at Sources of Supply	.....	.....	.....	.....
19. All Expenses of Intakes and Aqueducts	.....	.....	.....	.....
20. All Expenses of Purification system	.....	.....	.....	.....
21. All Expenses of Pumping System	.....	.....	.....	.....
22. All Expenses of Transmission and Distribution Storage System	.....	.....	.....	.....
23. All Expenses of Distribution System	.....	.....	.....	.....
24. Total Exp. of Wtr. Service	.....	.....	.....	.....
25. Six % of Value of Assets	.....	.....	.....	.....
26. Net Anticipated Income from Operation	.....	.....	.....	.....
27. Net Income from Operation Realized	.....	.....	.....	.....
28. Interest Expenses	.....	.....	.....	.....
29. Anticipated Profit or loss	.....	.....	.....	.....
30. Profit or Loss Realized	.....	.....	.....	.....

PROPOSED CENSUS SCHEDULE FOR SECURING UNIFORM REPORTS OF THE TRANSACTIONS AND CONDITION OF WATER-SUPPLY ENTERPRISES

PART I. FINANCIAL TRANSACTIONS FOR YEAR ENDING.....

INCOME

I. *Income from Water Service:*		
A. (1 and 3) Domestic Pay Rates Within City	$.....	
A. (2 and 4) Manufacturing and Commercial Pay Rates Within City	.....	
B. (5 and 7) Domestic Pay Rates Outside of City	.....	
B. (6 and 8) Manufacturing and Commercial Pay Rates Outside of City	.....	
C. Pay Rates for Other Water Companies	.....	
D. Fees for Shutting off and Turning on Water	.....	
E. Pay Rates for City	.....	
F. Free Rates for City	.....	
G. Free Rates for Private Consumers	.....	
H. Water Used by Water-Supply System	.....	
		$.....
II. Income Other Than From Water Service:		
I. Income from Accessory Enterprises	$.....	
J. Earnings of Invested Funds	.....	
K. Interest on Cash Balances in Bank	.....	
L. Income from Miscellaneous Sources	.....	
		.....
Gross Income from Operation		$.....

EXPENSES

GROUP 1. EXPENSES OF WATER SERVICES

III. Expenses for General Management	$.....	
IV Expenses for Collecting and Supplying Water:		
P. Expenses for Care of Source of Supply	.....	
Q. Expenses for Care of Intakes and Aqueducts	.....	
R. Expenses for Purification of Water	.....	
S. Expenses for Pumping Water	.....	
T. Expenses for Transmission and Distribution Storage of Water	.....	
U. Expenses for Distribution of Water	.....	
		$.....
V. Expenses for Water Service Repairs:		
MM. Repairs of General Management Buildings and Equipment	$.....	
PP. Repairs at Sources of Supply	.....	
QQ. Repairs of Intakes and Aqueducts	.....	
RR. Repairs to Purification System	.....	
SS. Repairs of Pumping System	.....	
TT. Repairs of Transmission and Distribution Storage System	.....	
		$.....

EXPENSES OF WATER SERVICES—CONTINUED

VI. Expenses for General and Water Service Insurance		$.....
VII. Expenses for General and Water Service Depreciation		.....
Total Expenses for Water Service		$.....

GROUP 2. EXPENSES OTHER THAN FOR WATER SERVICE

VIII. Miscellaneous Expenses:		
V. Expenses of Accessory Enterprises	$.....	
W. Expenses of Invested Funds	.....	
X. Sundry Expenses	.....	
		$.....
IX. First Charges for Water and Taxes:		
Y. Cost of Water	$.....	
Z. Division 1.—Taxes and Franchise Dues Other Than Those Paid to Operating City	.....	
Z. Division 2.—Taxes Paid by Municipally Operated Enterprise to City	.....	.....
Total Expenses of Operation		$.....

PROFIT AND LOSS ACCOUNT

Gross Income from Operation	$.....	
Total Expenses of Operation	.....	.....
Gross Profit or Net Income from Operation*		$.....
Interest		.....
Net Profit or Net Income Surplus†		$.....
Dividends and Assessments	$.....	
Net Investment Transfers		
Current Appropriation Surplus‡		.....

*The excess of expense is here called "total loss from operation."
†The excess of interest and other expenses is here called "net loss."
‡The excess of all expenses, charges, and payments is here called "deficit."

(FORM 21—Concluded)

PROPOSED CENSUS SCHEDULE FOR SECURING UNIFORM REPORTS OF THE TRANSACTIONS OF WATER-SUPPLY ENTERPRISES—Continued

Part II.—Summary of the Cost of Water-Supply System and of its Extensions, Additions and Renewals

Object of Outlays	Original Cost	Value of System at Beginning of Year	Changes During Year			Value of System at Close of Year
			Extensions, Additions and Renewals	Depreciation	Scrap Value of Displaced Equipment	
XX. Value as a going Concern:						
A. Preliminary Expenditures	.....	.....	.....	.....	.....	.....
B. Franchise	.....	.....	.....	.....	.....	.....
XXI, XXII. Value of Land and Equipment:						
C. For General Management	.....	.....	.....	.....	.....	.....
F. At Sources of Supply	.....	.....	.....	.....	.....	.....
G. For Intakes and Aqueducts	.....	.....	.....	.....	.....	.....
H. For Purification Works	.....	.....	.....	.....	.....	.....
I. For Pumping Stations	.....	.....	.....	.....	.....	.....
J. For Distribution Storage System	.....	.....	.....	.....	.....	.....
K. For Distribution System	.....	.....	.....	.....	.....	.....
XXIV. Water Rights:	.....	.....	.....	.....	.....	.....
XXV. Teams, Tools and Accessories	.....	.....	.....	.....	.....	.....
Grand Total	.....	.....	.....	.....	.....	.....

(Form 22)

PROPOSED CENSUS SCHEDULE FOR SECURING UNIFORM REPORTS OF THE TRANSACTIONS OF WATER-SUPPLY ENTERPRISES.—Continued

Part III.—Condensed Balance Sheet

Total Assets:

Miscellaneous Cash	$.....
Income Arrears (Recoverable)	.....
Accrued and Unassessed Income of Current Year	.....
Sundry Debtors	.....
Materials and Supplies	.....
Investments	.....
Sinking and Other Reserve Funds	.....
Present Value of Physical Property	.....
Operating Works or Property	.....
Accessory Property	.....
Deficit (In the case of Municipally Owned Water-Supply System this is a liability of the city to the enterprise)	.....

Liabilities and Proprietary Interests:

Debt Liabilities:

Deposits by Customers	$.....
Income for future Period Levied in Advance	.....
Audited Bills and Warrants Outstanding	.....
Notes Payable, Revenue Loans, etc	.....
Interest and dividends	.....
Sundry creditors	.....
Bonds, Debentures, etc	.....

Proprietary Interests:

City	$.....
Corporation	.....
Capital Stock	.....
Surplus	.....

(NATIONAL BANK REPORT)

Enter charter No. of Bank here.

(USE THE BLANK LINES IF NECESSARY, BUT DO NOT ERASE OR CHANGE ANY OF THE PRINTED ITEMS.)

No.....

REPORT OF THE CONDITION OF "THE....."

AT....., IN THE STATE OF....., AT THE CLOSE OF BUSINESS

ON THE..... DAY OF....., 190

DR.

RESOURCES			DOLLARS			CTS.
1.	Loans and Discounts (see schedule)					
2.	Overdrafts, secured, $.....; unsecured, $..... (see schedule)					
3.	U. S. Bonds to secure Circulation (par value) ..... per cents,..... per cents					
4.	U. S. Bonds to secure U. S. Deposits (par value)..... per cents					
5.	Other Bonds to secure U. S. Deposits					
6.	U.S. Bonds on hand (par value)..... ...per cents					
7.	Premium on Bonds for Circulation, $.....; Premium on other U.S. Bonds, $					
8.	Bonds, Securities, etc., including premium on same (see schedule)					
9.	Banking House, $.....; Furniture and Fixtures $					
10.	Other Real Estate owned (see schedule)					
11.	Due from National Banks (not approved reserve agents)					
12.	Due from State and Private Banks and Bankers, Trust Companies, and Savings Banks					
13.	Due from approved Reserve Agents (see schedule)					
14.	Checks and other Cash Items (see schedule)					
15.	Exchanges for Clearing House					
16.	Notes of other National Banks					
17.	Fractional Paper Currency, Nickels, and Cents					
18.	Lawful Money Reserve in Bank. Specie, viz.:	Clearing-H'se C'tfic't's (Sec. 5192)	$..			
		Gold Coin				
		Gold Certificates				
		Gold Certificates payable to order				
		Silver Dollars				
		Silver Certificates				
		Fractional Silver Coin				
		TOTAL COIN AND CERTIFICATES				
		Legal-Tender Notes				
19.	Redemption Fund with U. S. Treasurer (not more than 5 per cent on Circulation)					
20.	Due from U. S. Treasurer					
	TOTAL (to avoid discrepancies the total should be footed)					

Place for official seal to be affixed by officer before whom acknowledged. See Act Feb. 26, 1881. Notary must not be an officer or director of the bank.

State of.....County of.....

Sworn to and subscribed before me this.....

day of....., 190 ; and I..... hereby certify that I am not an officer or a director of this bank.

.....

Notary Public.

(FORM 24)

REPORT OF THE CONDITION OF "THE....."

AT....., IN THE STATE OF....., AT THE CLOSE OF BUSINESS

ON THE.....DAY OF....., 190

CR.

LIABILITIES	DOLLARS	CTS.
1. Capital Stock paid in		
2. Surplus fund		
3. Undivided Profits (including amounts, if any, set aside for special purposes, except Item 22) $ ... Less Current Expenses, Interest, and Taxes paid		
4. Circulating Notes secured by U.S. Bonds $ ... Less amount on hand and in Treasury for redemption or in transit		
5. State Bank Circulation outstanding		
6. Due to National Banks (not approved Reserve Agents)		
7. Due to State and Private Banks and Bankers		
8. Due to Trust Companies and Savings Banks		
9. Due to approved Reserve Agents (see schedule)		
10. Dividends unpaid		
11. Individual Deposits subject to Check $ ...		
12. Savings Deposits		
13. Demand Certificates of Deposit		
14. Time Certificate of Deposit		
15. Certified Checks		
16. Cashier's Checks outstanding		
17. United States Deposits		
18. Deposits of U. S. Disbursing Officers		
19. Bonds Borrowed		
20. Notes and Bills rediscounted		
21. Bills payable, including Certificates of Deposit representing money borrowed		
22. Reserved for Taxes		
23. Liabilities other than those above stated		
TOTAL (to avoid discrepancies the total should be footed)		

I, ... (Cashier or President), *of the above-named bank, do solemnly swear that the above statement is true, and that the SCHEDULES on back of the report fully and correctly represent the true state of the several matters therein contained, to the best of my knowledge and belief.*

Correct.—Attest: .....
Cashier.

NOTE.—This report must be sworn to by the PRESIDENT OR CASHIER, NOT BY ANY OTHER OFFICER; attested by not less than three Directors, and forwarded to the Comptroller of the Currency with the least possible delay, as it is desired to complete the summary of reports as soon as possible after a call has been issued.

To be attested by three Directors other than the officer verifying the report.

.....
.....
.....
} Directors.

(FORM 24—Continued)

CERTIFICATES OF DEPOSIT REPRESENTING MONEY BORROWED.

To whom issued	Address	Amount on demand	Amount on time	Rate of interest
TOTAL (include in Item 21, Liabilities)				

LOANS Exceeding the Limit Prescribed by Section 5200 of the Revised Statutes, including Amounts which Exceed this Limit due from State, Private Banks and Bankers, Trust Companies, and Savings Banks. Overdrafts, if any, to be classed with Loans.

Name of borrower	Enter full amount of loan	Name of borrower	Enter full amount of loan

From— BALANCES DUE FROM OR TO APPROVED RESERVE AGENTS *To*–

Enter name and location of bank	Amount	Enter name and location of bank	Amount
TOTAL (Item 13, Resources)		TOTAL (Item 9, Liabilities)	

LIABILITIES OF OFFICERS AND DIRECTORS

Names of officers and directors	Official title	Liability (individual or firm) as payers	Liability (individual or firm) as indorsers or guarantors	Checks and cash items	Overdrafts	No. of shares stock owned
	President					
	Cashier					
	Vice-Pres.					
	Asst. Cash.					
	Directors					
	do					
	do					
	do					
	do					
TOTAL						

(FORM 24—Continued)

LOANS AND DISCOUNTS. (Including Loans and Discounts on which Officers and Directors are Liable.)

A. On demand, paper with one or more individual or firm names....$			
B. On demand, secured by stocks, bonds, and other personal securities			
C. On time, paper with two or more individual or firm names.....			
D. On time, single name paper (1 person or firm) without other security			
E. On time, secured by stocks, bonds, and other personal securities.			
F. Secured by real estate mtgs. or other liens on realty (see schedule)			
TOTAL (Item 1, Resources).....			
Enter the amount in each of these items, or write in the word "none" if there is no amount to enter. INCLUDED IN THE ABOVE ARE— G. Bad debts, as defined in Section 5204, Revised Statutes.....$			
H. Other suspended or overdue paper.....			

X. Loans for account of correspondents made from their funds.....$

Secured:				OVERDRAFTS	*Unsecured:*		
Stand'g 6 mos. or over					Stand'g 6 mos. or over		
Temporary					Temporary		
Officers and Directors					Officers and Directors		
TOTAL (Item 2, Resources)					TOTAL (Item 2, Resources)		

BONDS, SECURITIES, ETC. (Bonds, Claims, Judgments, and similar items should be included under this head.)

Enter face value of bonds	Name of corporation issuing bonds, etc.	Amount at which carried on books	Estimated actual market value	State whether taken for "debts previously contracted
	TOTAL (Item 8, Resources)			

OTHER REAL ESTATE OWNED

Describe property, state form of conveyance, and from whom obtained	Amount at which carried on books	Amount of prior lien on property, if any	Estimated actual value of property	Date when title was acquired	St'te wh'ther taken for "debts previously contracted."
TOTAL (Item 10, Resources)					

LOANS AND DISCOUNTS Secured by Real Estate Mortgages or other Liens on Realty

Give name of borrower, form of collateral, and describe property	Amount at which carried on books	Amount of prior lien on property, if any	Estimated actual value of property	Date when security was taken	St'te wh'ther taken for "debts previously contracted."
TOTAL (Item "F," Loans and Disc.,					

CHECKS AND CASH ITEMS OTHER THAN EXCHANGES FOR C. H.

Checks and drafts on banks, etc., in this city, not members of clearing house.....			
Checks and drafts on other banks not members of clearing house.....			
Total (Item 14, Resources).....			

AVERAGE RESERVE AND INTEREST

Average reserve for last thirty days on deposits and bank balances in bank was..... per cent.
With Reserve Agents was..... per cent.
Aggregate was..... per cent.

The highest rate of interest paid by the bank on deposits is..... per cent.
On notes and bills rediscounted is..... per cent.
And on bills payable is..... per cent.

(FORM 24—Concluded)

.....BUILDING AND LOAN ASSOCIATION

BALANCE SHEET.....19....

ASSETS:

LOANS:

Real Estate Loans with Stock Collateral.....	$.....
Real Estate Loans without Stock Collateral.....	.....
Stock Loans.....	.....
	$.....
Real Estate	.....
Other Investments (if any; state nature).....	.....
Dues, Fines, etc., Delinquent.....	.....
Prepaid Insurance and Taxes.....	.....
Accrued Income.....	.....
Cash.....	.....
	$.....

LIABILITIES:

Loans Payable (if any).....	$.....
Unearned Premiums.....	.....
Dues, etc., Paid in Advance.....	.....
Accrued Taxes (if any).....	.....
SHARE CAPITAL:.	
Dues Paid in and Accrued Profits Thereon, Per Schedule of Series and Values, Annexed.....	.....
	$.....

(FORM 25)

PROFIT AND LOSS ACCOUNT

YEAR ENDED.....19.....

EARNINGS:

Interest		$.....
Premiums		.....
Fines		.....
Admission and Transfer Fees		.....
Rents of Real Estate	$.....	
Less, Insurance, Taxes, etc	.....	.....
Profit on Stock Withdrawals		.....
		$.....

EXPENSES:

Interest on Stock Withdrawn	$.....	
Interest on Borrowed Money	.....	
Administration Expenses	.....	.....
Net Profit for Apportionment Among Stock Series		$.....

(FORM 26)

RECEIPTS AND DISBURSEMENTS

YEAR ENDED.....19.....

BALANCE (Beginning of Year)		$.....
RECEIPTS:		
Dues	$.....	
Interest, Premiums and Fines	.....	
Admission and Other Fees	.....	
Rents	.....	
Loans Repaid	.....	
Sales of Real Estate	.....	
Money Borrowed	.....	.....
		$.....
DISBURSEMENTS:		
Loans	$.....	
Matured Stock	.....	
Stock Withdrawals	.....	
Salaries	.....	
Rent, Printing, Stationery and Sundry Expenses	.....	
Real Estate Expenses	.....	
Borrowed Money	.....	
Interest	.....	.....
BALANCE (End of Year)		$.....

(FORM 27)

STATEMENT OF SHARE CAPITAL

.....19.....

Series No.	Date of Issue	Shares			Value Per Share			Value of Series	Withdrawal Value per Share
		Borrowed on	Free	Total	Dues	Profits	Total		
.....	.....	.....	.....	.....	$.....	$...	$.....	$.....	$.....
.....	.....	.....	.....	.....	.....	....	.....	.....	.....
.....	.....	.....	.....	.....	.....	.....	....	.....	.....
		.....	.....	.....				$.....*	

*This amount should agree with the item of "Share Capital" shown in the balance sheet.

(Form 28)

THE IDEAL LIFE INSURANCE COMPANY
BALANCE SHEET, DECEMBER 31, 19..
ASSETS

REAL ESTATE—(Appraised Value):			
Office Buildings:			
Home Office	$.....		
Domestic Branches	.....		
Foreign Branches	.....		
	———	$.....	
Other Real Estate		.....	
		———	$.....
SECURED LOANS:			
On Mortgage		$.....	
On Policies		.....	
On Other Collateral		.....	
		———	$.....
BONDS, STOCKS AND OTHER MARKETABLE SECURITIES—(Market Value):			
Bonds:			
Governm't, State and Municipal of the United States and Canada	$.....		
Railroad and Traction Companies in the United States and Canada	.....		
Foreign—Held Chiefly to Comply With Statutory Requirements.	.....		
Miscellaneous	.....		
Stocks:	———	$.....	
Railroad and Traction Companies in the United States and Canada	$.....		
Financial and Insurance Companies in the United States and Canada	.....		
Miscellaneous	.....		
	———	$.....	
Syndicate Subscriptions		.....	
		———	$.....
CASH:			
In Banks and Trust Companies:			
Home Office Subject to Check	$.....		
Branches and Agencies, Subject to Check	.....		
On Deposit on Special Terms	.....		
	———	$.....	
Deposits with Foreign Governments		.....	
In Transit		.....	
On Hand—At Home Office, Branches and Agencies		.....	
		———	$.....
PREMIUMS IN COURSE OF COLLECTION OR COLLECTED AND NOT REPORTED:			
First Year Premiums		$.....	
Renewal Premiums		.....	
Annuities		.....	
		———	$.....
AGENTS' BALANCES AND MISCELLANEOUS ADVANCES			.....
INTEREST AND RENTALS DUE OR ACCRUED:			
Interest:			
On Bonds and Dividends on Stocks	$.....		
On Secured Loans	.....		
On Agents' Advances and Balances	.....		
Miscellaneous	.....		
	———	$.....	
Rentals		.....	
		———	.....
			———
			$.....

THE IDEAL INSURANCE COMPANY

BALANCE SHEET, DECEMBER 31, 19...

LIABILITIES:

General Insurance Reserve: (Describing Basis).....			$.....
Current Liabilities:			
Under Policies and Policy Contracts:			
Death Claims—Due and Unpaid...	$.....		
Matured Endowments.....	.....		
Annuities—Due and Unpaid.....	.....		
Dividends—Due and Unpaid.....	.....	$.....	
Commissions and Current Expenses:			
Commissions on Premiums in Course of Collections.....	$.....		
Current Expenses.....	.....	$.....	
			$.....
Premiums, Interest and Rents Prepaid, and Sundry Deposits....			.....
			.....
Capital Stock:.....			
Surplus and Reserves:			
Contingency Fund.....		$.....	
Investment Fluctuation Reserve Fund		.....	
Deferred Dividend Funds.....		.....	
Annual Dividend Funds.....		.....	
Unappropriated Surplus.....		.....	.....
			$.....

(Form 29—Concluded)

THE IDEAL LIFE INSURANCE COMPANY
ASSURANCE ACCOUNT FOR THE YEAR ENDED DECEMBER 31, 19.....

PREMIUMS FALLING DUE WITHIN THE YEAR:			BENEFITS UNDER POLICIES:		
First Year	$.....		Claims on death or maturity after deduction of $ applied to purchase Annuities and Instalments	$.....	
Renewal	.....		Annuities and Instalments	.....	
Annuities	.....		Surrender Values after deduction of $ applied to purchase Paid-up Insurance	.....	
		$.....			$.....
EARNINGS ON INVESTMENTS AFTER DEDUCTION OF TAXES AND OTHER EXPENSES DIRECTLY APPLICABLE THERETO:			EXPENSE OF CONDUCTING BUSINESS:		
Interest and Dividends	$.....		Commissions	$.....	
Rents, less Expenses	.....		Agency Expenses (Abstract A)	.....	
Profits on Sales of Bonds and Stocks, Net	.....		Administration, General Expenses (Abstract B)	.....	
Gain in Market Values	.....		Insurance Taxes	.....	
		.....			.....
Total Income		$.....	Total Outgo		$.....
DIVIDENDS APPLIED TO PURCHASE PAID-UP INSURANCE AND ANNUITIES		.....	RESERVE ON POLICIES IN FORCE DECEMBER 31, 19.....		.....
RESERVE ON POLICIES IN FORCE, JANUARY 1, 19.....		.....	SURPLUS FOR THE YEAR		.....
		$.....			$.....

SURPLUS ACCOUNT

19.....			19.....			
Jan. 1.	SURPLUS AS PER PREVIOUS ACCOUNT	$.....	Dec. 31.	APPROPRIATIONS:		
				For Contingency Fund	$.....	
Dec. 31.	SURPLUS FOR THE YEAR AS PER ASSURANCE ACCOUNT	.....		For Investments Fluctuation Reserve Fund	.....	
						$.....
				DIVIDENDS TO STOCKHOLDERS		.....
				DIVIDENDS TO POLICY HOLDERS		.....
				BALANCE—Being Surplus at December 31, 19...., as per Balance Sheet		.....
		$.....				$.....

(FORM 30)

THE IDEAL LIFE INSURANCE COMPANY

ABSTRACT "A".

AGENCY EXPENSES FOR THE YEAR ENDED DECEMBER 31, 19.....

	State or Country	Total Expense			Rents	Salaries	Allowances	Bonuses and Prizes	Printing and Stationery	Postage and Exchange	Traveling Expenses	Office and Sundry Expenses	Furniture
		Total	Apportioned to										
			New Business	Renewal									
DOMESTIC													
Total Domestic													
FOREIGN													
Total Foreign													
Total Domestic and Foreign													

(FORM 31)

THE IDEAL LIFE INSURANCE COMPANY

ABSTRACT "B"

ADMINISTRATION AND GENERAL EXPENSES FOR THE YEAR ENDED DECEMBER 31, 19.....

Departments	Total Cost			Rent	Salaries and Pensions	Directors' and Committees' Fees	Traveling Expenses	Banquets and Conventions	Advertising	Printing and Stationery	Postage Cables and Telephones	Legal Expenses	Furniture and Fixtures	Audit of Accounts	Sundry Office Expenses
	Total	Apportioned to													
		New Business	Renewal												
Executive															
Secretary															
Financial															
Supplies															
Real Estate															
Supplies															
Cashier															
Accounting															
Actuarial															
Auditing—Domestic															
Auditing—Foreign															
Agency—Domestic															
Agency—Foreign															
Issue of Insurance															
Policy Loans															
Claims															
Surrender Values															
Advertising															
Medical															
Legal															

(Form 32)

(PRESCRIBED STATE FORM)

ANNUAL STATEMENT OF THE ..... LIFE INSURANCE COMPANY

I.—CAPITAL STOCK

1.	Amount of Capital Paid up in Cash	$.....		
2.	Amount of Ledger Assets (as per Balance) December 31 of Previous Year		$.....	
3.	.. crease of Capital during the Year		.....	
				$.....
4.		Extended at		

II.—INCOME

5.	First Year's Premiums on Original Policies, without Deductions for Commissions or Other Expenses, Less $..... .. for First Year's Reinsurance	$.....		
6.	Surrender Values Applied to Pay First Year's Premiums	.....		
7	Total First Year's Premiums on Original Policies	$.....		
8.	Dividends Applied to Purchase Paid-up Additions and Annuities	.....		
9.	Surrender Values Applied to Purchase Paid-up Insurance and Annuities	.....		
10.	Consideration for Original Annuities Involving Life Contingencies	.....		
11.	Consideration for Supplementary Contracts Involving Life Contingencies	.....		
12.	Total new premiums		$.....	
13.	Renewal Premiums (in Addition to Items 14, 15 and 16), without Deductions for Commissions or Other Expenses, Less $..... for Reinsurance on Renewals	$.....		
14.	Dividends Applied to Pay Renewal Premiums	.....		
15.	Surrender Values Applied to Pay Renewal Premiums	.....		
16.	Renewal Premiums for Deferred Annuities	.....		
17.	Total Renewal Premiums	.....	.....	
18.	Total Premium Income	.....	$.....	
19.	(*A*) Consideration for Supplementary Contracts *not* Involving Life Contingencies	.....	.....	
20.	Dividends Left with the Company to Accumulate at Interest	.....	.....	
21.	Ledger Assets, Other Than Premiums, Received from Other Companies for Assuming Their Risks	.....	.....	

(A) Including commuted value of instalments or other benefits not payable at the time of death or maturity of endowments, such commuted value being entered under No. 1 or 2 of Disbursements.

		$.....		
22.	Gross Interest on Mortgage Loans	.....		
23.	Gross Interest on Collateral Loans, per Schedule C	.....		
24.	Gross Interest on Bonds and Dividends on Stocks, Less $..... Accrued Interest on Bonds Acquired During 1908, per Schedule D	.....		
25.	Gross Interest on Premium Notes, Policy Loans or Liens	.....		
26.	Gross Interest on Deposits in Trust Companies and Banks	.....		
27.	Gross Interest on Other Debts Due the Company	.....		
28.	Gross Discount on Claims Paid in Advance	.....		
29.	Gross Rent from Company's Property, Including $..... for Company's Occupancy of Its own Buildings, per Schedule A	.....		
30.	Total Gross Interest and Rents	.....	.....	
31.	From Other Sources (give Items and Amounts):	$.....		
32.	.....	.....		
33.	.....	.....		
34.	.....	.....		
35.	.....	.....	.....	
36.	.....		.....	
37.	From Agents' Balances Previously Charged off			
38.	Gross Profit on sale or Maturity of Ledger Assets, viz:	$.....		
	(a) Real Estate, per Schedule A	.....		
	(b) Bonds, per Schedule D	.....		
	(c) Stocks, per Schedule D	.....	.....	
39.	Gross Increase, by Adjustment, in Book Value of Ledger Assets, viz:	$.....		
	(a) Real Estate, per Schedule A	.....		
	(b) Bonds, per Schedule D	.....		
	(c) Stocks, per Schedule D	.....	.....	
				$.....
40.	Total Income			$.....
41.	Amount Carried Forward			

NOTE. The forms for the detailed schedules A, B, C and D are not reproduced herein.

(FORM 33—Continued)

Amount Brought Forward..... $..... $..... $.....

III.—DISBURSEMENTS

1. (*A*) For Death Claims (Less ..... Reinsurance), $.....; Additions, $..... .....
2. (*A*) For Matured Endowments (Less $..... Reinsurance), $.....; Additions, $....., ...
3. Net Amount Paid for Losses and Matured Endowments..... ....
4. For Annuities Involving Life Contingencies..... ....
5. Premium Notes and Liens Voided by Lapse, Less $..... Restorations..... ....
6. Surrender Values Paid in Cash, or Applied in Liquidation of Loans or Notes..... ....
7. Surrender Values Applied to Pay New Premiums (see Income No. 6) $.....; to Pay Renewal Premiums (see Income No. 15), $..... ....
8. Surrender Values Applied to Purchase Paid-up Insurance and Annuities (see Income No. 9) ....
9. Dividends Paid to Policyholders in Cash, or Applied in Liquidation of Loans or Notes..... ....
10. Dividends Applied to Pay Renewal Premiums (see Income No. 14)..... ....
11. Dividends Applied to Purchase Paid-up Additions and Annuities (see Income No. 8)..... ....
12. Dividends Left with the Company to Accumulate at Interest (see Income No. 20)..... ....
13. (Total Paid Policy Holders, $.....)
14. Expense of Investigation and Settlement of Policy Claims Including $..... for Legal Expense..... ....
15. Paid for Claims on Supplementary Contracts not Involving Life Contingencies..... ....
16. Dividends Held on Deposit Surrendered During the Year $..... with Interest thereon, $..... ....
17. Paid Stockholders for Interest or Dividends..... ....
18. Commissions to agents (less Commission or Reinsurance):
    First Year's Premiums, $.....; Renewal Premiums, $.....; Annuities (Original), $.....; (Renewal), $..... ....
19. Commuted Renewal Commissions..... ....
20. Salaries and Allowances for Agencies, Including Managers, Agents and Clerks..... ....
21. Agency Supervision, Traveling, and all Other Agency Expenses..... ....
22. Medical Examiners' fees, $.....; Inspection of Risks..... ....
23. Salaries and All Other Compensation of Officers, Directors, Trustees and Home Office Employees ....
24. Rent, Including $.....for Company's Occupancy of Its Own Buildings, Less $.....Received Under Sublease..... ....
25. Advertising, $.....; Printing and Stationery, $.....; Postage, Telegraph, Telephone and Express, $.....; Exchange, $..... ....

(*A*) Including commuted value of supplementary contracts—See No. 19 of Income.

	Amount Brought Forward	$	$	$
26.	Legal Expense not Included in Item 14			
27.	Furniture, Fixtures and Safes			
28.	Repairs and Expenses (Other Than Taxes) on Real Estate			
29.	Taxes on Real Estate			
30.	State Taxes on Premiums			
31.	Insurance Department Licenses and Fees			
32.	All Other Licenses, Fees and Taxes (Give Items and Amounts):			
33.				
34.				
35.				
36.	Other Disbursements (Give Items and Amounts):	$		
37.				
38.				
39.				
40.				
41.				
42.				
43.	Agents' Balances Charged Off	$		
44.	Gross Loss on sale or Maturity of Ledger Assets, Viz:			
	(a) Real Estate, per Schedule A			
	(b) Bonds, per Schedule D,			
	(c) Stocks, per Schedule D			
45.	Gross Decrease, by Adjustment, in Book Value of Ledger Assets, Viz:			
	(a) Real Estate, per Schedule A	$		
	(b) Bonds, per Schedule D			
	(c) Stocks, per Schedule D			
46.	Total Disbursements			
47.	Balance			$

IV—LEDGER ASSETS.

1.	Book Value of Real Estate, per Schedule A	$.....	
2.	Mortgage Loans on Real Estate, per Schedule B, First Liens, $.....; other than First Liens, $.....	.....	
3.	Loans Secured by Pledge of Bonds, Stocks or Other Collateral, Per Schedule C	.....	
4.	Loans Made to Policyholders on this Company's Policies Assigned as Collateral	.....	
5.	Premium Notes on Policies in Force, of Which $..... is for First Year's Premiums	.....	
6.	Book Value of Bonds, $.....; and Stocks, $..... per Schedule D	.....	
7.	Cash in Company's Office	.....	
8.	Deposits in Trust Companies and Banks, not on Interest	.....	
9.	Deposits in Trust Companies and Banks, on Interest	.....	
10.	Bills Receivable, $.....; Agents' Balances (Debit, $.....; Credit, $.....); net, $	.....	
11.	.....		
12.	Total Ledger Assets, as per Balance on Page 3 [Preceding Page]		$.....

NON-LEDGER ASSETS.

13.	Interest Due, $..... and Accrued, $..... on Mortgages, per Schedule B	$.....	
14.	Interest Due, $..... and Accrued, $..... on Bonds, per Schedule D, Part I	.....	
15.	Interest Due, $..... and Accrued, $..... on Collateral Loans, per Schedule C, Part 1	.....	
16.	Interest Due, $..... and Accrued, $..... on Premium Notes, Policy Loans or Liens	.....	
17.	Interest Due, $..... and Accrued, $..... on Other Assets	.....	
18.	Rents Due, $..... and Accrued, $..... on Company's Property or Lease	.....	
19.	Total Interest and Rents Due and Accrued		.....
20.	Market Value of Real Estate over Book Value, per Schedule A		.....
21.	Market Value (not Including Interest in Item 14), of Bonds and Stocks over Book Value, per Schedule D		.....
22.	Due from other Companies for Losses or Claims on Policies of this Company, Reinsured		.....

(Form 33—Continued)

		(1) New Business	(2) Renewals		
23.	Gross Premiums Due and Unreported on Policies in Force December 31, 1908	$.....	$.....		
24.	Gross Deferred Premiums on Policies in Force December 31, 1908				
25.	Totals,	$.....	$.....		
26.	Deduct Loading				
27.	Net Amount of Uncollected and Deferred Premiums	$.....	$.....		
28.	All Other Assets (give Items and Amounts)			.....	.....
29.	.....			.....	.....
30.	.....			.....	.....
31.	.....			.....	.....
32.	.....			.....	.....
33.	Gross Assets			.....	$.....

DEDUCT ASSETS NOT ADMITTED

34.	Company's Stock Owned $.....; Loans on $	$.....	
35.	Supplies, Stationery, Printed Matter, $.....; Furniture, Fixtures and Safes, $	.....	
36.	Commuted Commissions, $.....; Agents' Debit Balances, $	.....	
37.	Cash Advanced to or in the Hands of Officers or Agents	.....	
38.	Loans on Personal Security, Endorsed or not, $.....; Bills Receivable, $	.....	
39.	Premium Notes and Loans on Policies and net Premiums in Item 27 in Excess of the Net Value of Their Policies	.....	
40.	Book Value of Ledger Assets over Market Value, viz:	.....	
41.	.....	.....	
42.	.....	.....	.....
43.	Admitted Assets		$.....

(Form 33—Continued)

V—LIABILITIES

Net Present Value of All the Outstanding Policies in Force on the 31st Day of December, 1908, as Computed by the.....on the Following Tables of Mortality and Rates of Interest, viz.:

1.	Actuaries' Table at.....Per Cent. on*.....		
	.....		
	.....	$.....	
	Same for Reversionary Additions.....	.....	$.....
2.	American Experience Table at.....Per Cent. on*.....		
	.....		
	.....	$.....	
	Same for Reversionary Additions.....	.....	.....
3.	American Experience Table at.....Per Cent. on*.....		
	.....		
	.....	$.....	
	Same for Reversionary Additions.....	.....	.....
4	Other Tables and Rates, viz.:*		
	.....	$.....	
	.....	.....	
	.....	.....	
	.....	.....	
	Same for Reversionary Additions.....	.....	.....
5.	Net Present Value of Annuities (including those in Reduction of Premiums). Give Tables and Rates of Interest, viz.:		
	.....	$.....	
	.....	.....	
	.....	.....	.....
	Total.....		$.....

*State definitely the dates of issue and class of policies covered by each basis of valuation.

(FORM 33—Continued)

ANNUAL STATEMENT OF THE.....LIFE INSURANCE COMPANY—CONTINUED

V—LIABILITIES—CONTINUED

6.	Deduct Net Value of Risks of this Company Reinsured in other Solvent Companies.....	$.....	
		$.....	
7.	Reserve to Provide for Health and Accident Benefits Contained in Life Policies.....	.....	
8.	NET RESERVE.....		$.....
9.	Present Value of Amounts not yet Due on Supplementary Contracts *not* involving Life Contingencies, Computed by the.....		.....
10	Liability on Policies Cancelled and not Included in "Net Reserve" upon which a Surrender Value may be Demanded.....		.....
11.	Claims for Death Losses Due and Unpaid.....	$.....	
12.	Claims for Death Losses in Process of Adjustment, or Adjusted and not Due.....	.....	
13.	Claims for Death Losses which have been Reported and no Proofs Received.....	.....	
14.	Claims for Matured Endowments Due and Unpaid.....	.....	
15.	Claims for Death Losses and Other Policy Claims Resisted by the Company.....	.....	
16.	Due and Unpaid on Annuity Claims Involving Life Contingencies.....	.....	
17.	TOTAL POLICY CLAIMS.....		.....
18.	Due and Unpaid on Supplementary Contracts *not* Involving Life Contingencies.....		.....
19.	Dividends left with the Company to Accumulate at Interest, $.....; and Accrued Interest Thereon, $.....		.....
20.	Premiums Paid in Advance, Including Surrender Values so Applied.....		.....
21.	Unearned Interest and Rent Paid in Advance.....		.....
22.	Commissions Due to Agents on Premium Notes when Paid.....		.....
23.	Commissions to Agents, Due or Accrued.....		.....
24.	"Cost of Collection" on Uncollected and Deferred Premiums, in Excess of the Loading Thereon (New Business, $.....; Renewals, $.....).....		.....
25.	Salaries, Rents, Office Expenses, Bills and Accounts Due or Accrued.....		.....
26.	Medical Examiners' and Legal Fees Due or Accrued.....		.....
27.	State, County and Municipal Taxes Due or Accrued.....		.....
28.	Advances by Officers or Others on Account of Expenses of Organization or Otherwise.....		.....
29.	Borrowed Money $.....and Interest Thereon $.....		.....

(FORM 33—Continued)

V—LIABILITIES—CONTINUED

		$
30.	Unpaid Dividends to Stockholders	
31.	Dividends or Other Profits due Policyholders, Including Those Contingent on Payment of Outstanding and Deferred Premiums	
32.	Dividends Declared on or Apportioned to *Annual Dividend* Policies Payable to Policyholders During 1909, whether Contingent upon the Payment of Renewal Premiums or Otherwise	
33.	Dividends Declared on or Apportioned to *Deferred Dividend* Policies Payable to Policyholders During 1909	
34.	Amounts Set Apart, Apportioned, Provisionally Ascertained, Calculated, Declared or Held Awaiting Apportionment Upon *Deferred Dividend* Policies, not Included in Item 33	
35.	Reserve or Surplus Funds not Otherwise Included in Liabilities (give Items and Amounts Separately, and State for What Purpose Each of Said Funds is Held :)	
36.		
37.		
38.		
39.	All Other Liabilities (give Items and Amounts):	
40.		
41.		
42.		
43.		
44.	Capital Stock	
45.	Unassigned Funds (Surplus)	
46.	Total Liabilities	$

(FORM 33—Continued)

GAIN AND LOSS EXHIBIT

For the year ending December 31, 1908, showing the Sources of the Increase and the Decrease in the Surplus during the year

INSURANCE EXHIBIT

RUNNING EXPENSES

				Gain in Surplus	Loss in Surplus
1.	Gross Premiums received during the year, per item 18, page 2.....	$.....			
2.	Deduct Gross Uncollected and Deferred Premiums of the previous year, per item 25, page 4, of the Annual Statement for said year..	.....			
3.	Balance.....	.....			
4.	Add Gross Uncollected and Deferred Premiums December 31, 1908, per item 25, page 4.....	.....			
5.	Total.....	.....			
6.	Deduct Gross Premiums paid in advance December 31, 1908, per item 20, page 5.....	.....			
7.	Balance.....	.....			
8.	Add Gross Premiums paid in advance December 31 of previous year, per item 19, page 5, of the Annual Statement for said year.....	.....			
9.	Gross Premiums of the year.....	.....			
10.	Deduct Net Premiums on the same.....	.....			
11.	**Loading on Gross Premiums of the year (averaging..... per cent. of the Gross Premiums)**.....		$.....		
12.	†Insurance Expenses Paid during the year.....	.....			
13.	Deduct Insurance Expenses Unpaid, December 31 of previous year (including $..... loading on Uncollected and Deferred Premiums).....	.....			
14.	Balance.....	.....			
15.	Add Insurance Expenses Unpaid December 31, 1908 (including $..... loading on Uncollected and Deferred Premiums)....	.....			
16.	**Insurance Expenses incurred during the year**.....		.....		
17.	*.....**from Loading**.....			$.....	$.....

*Write "Gain" or "Loss". †Describe Method Used

(FORM 33—Continued)

GAIN AND LOSS EXHIBIT—CONTINUED

				Gain in Surplus	Loss in Surplus
	INTEREST				
18.	Interest, Dividends and Rents received during the year, per item 30, page 2		.....		
19.	Deduct Interest and Rents Due and Accrued December 31, of **previous** year, per item 19, page 4, of the Annual Statement for said year	.....			
20.	Balance	.....			
21.	Add Interest and Rents Due and Accrued December 31, 1908, per item 19, page 4	.....			
22.	Total	.....			
23.	Deduct Interest and Rents Paid in Advance December 31, 1908, per item 21, page 5	.....			
24.	Balance	.....			
25.	Add Interest and Rents Paid in Advance December 31 of **previous** year, per item 20, page 5, of the Annual Statement for said year	.....			
26.	**Interest Earned during the year**		.....		
27.	†Investment Expenses Paid during the year	.....			
28.	Deduct Investment Expenses Unpaid December 31 of **previous** year	.....			
29.	Balance	.....			
30.	Add Investment Expenses Unpaid December 31, 1908	.....			
31.	**Investment Expenses incurred during the year**		.....		
32.	**Net Income from Investments**		.....		
33.	†**Interest required to Maintain Reserve**		.....		
34.	*.....**from Interest**			.....	.....
				$.....	$.....

Amounts Carried forward

*Write "Gain" or "Loss". †Describe Method Used.

(FORM 33—Continued)

GAIN AND LOSS EXHIBIT—CONTINUED

				Gain in Surplus	Loss in Surplus
				$.....	$.....
	Amount brought forward		$.....		
	MORTALITY				
35.	**Expected Mortality on Net Amount at Risk**		.....		
36.	Death Losses Paid during the year per item 1, page 3	$.....			
37.	Deduct Death Losses Unpaid December 31 of previous year per items 11, 12, 13 and 15, page 5, of the Annual Statement for said year	.....			
		———			
38.	Balance	.....			
39.	Add Death Losses Unpaid December 31, 1908, per items 11, 12, 13 and 15, page 5	.....			
		———			
40.	Death Losses Incurred during the year including the Commuted Value of Installment Death Losses	.....			
41.	Deduct Terminal Reserves Released by Death of Insured	.....			
		———			
42.	**Actual Mortality on Net Amount at Risk**		.....		
			———		
43.	*.....**from Mortality**			.....	.....
	ANNUITIES				
44.	Expected Disbursements to Annuitants		.....		
45.	Deduct Reserve Expected to be Released by Death		.....		
			———		
46.	**Net Expected Disbursements to Annuitants**		.....		
47.	Actual Annuity Claims Incurred	.....			
48.	Deduct Reserves Released by Death of Annuitants	.....			
		———	.....		
49.	**Net Actual Annuity Claims Incurred**		———		
50.	*.....**from Annuities**			.....	.....

*Write "Gain" or "Loss". †Describe Method Used.

(Form 33—Continued)

GAIN AND LOSS EXHIBIT—Continued

				Gain in Surplus	Loss in Surplus
	SURRENDERS, LAPSES AND CHANGES				
51.	Terminal Reserves on Policies and Additions Surrendered for Cash Value during the year				
52.	Deduct Amount Paid on the same				
53.	Gain during the year on said Policies Surrendered for Cash				
54.	Terminal Reserves on Policies on Account of which Extended Insurance was granted during the year				
55.	Deduct Indebtedness and Initial Reserves on said Extended Insurance				
56.	Gain during the year on Extended Insurance				
57.	Terminal Reserves on Policies Exchanged during the year for Paid-up Insurance				
58.	Deduct Indebtedness and Initial Reserves on said Paid-up Insurance				
59.	Gain during the year on said Paid-up Insurance				
60.	*.....from Changes and Restorations made during the year				
61.	Gain during the year from Reserves Released on Lapsed Policies on which no Cash Value, Paid-up or Extended Insurance was allowed				
62.	Total				
63.	....crease during the year in Unpaid Surrender Values per item 10, page 5				
64.	**Total gain during the year from Surrendered and Lapsed Policies**				
65.	Amounts carried forward			$	$

*Write "Gain" or "Loss". †Decsribe Method Used.

(FORM 33—Continued)

	GAIN AND LOSS EXHIBIT—CONTINUED		Gain in Surplus	Loss in Surplus
66.	Amounts brought forward	$.....	$.....	$.....
	DIVIDENDS			
67.	**Dividends Paid Stockholders**			.....
68.	Dividends Paid Policyholders in Cash	.....		
69.	Dividends Applied to Pay Renewal Premiums	.....		
70.	Dividends Applied to Purchase Paid-up Additions and Annuities	.....		
71.	Increase in Unpaid, Deferred and Apportioned Dividends	.....		
72.	Total	.....		
73.	Deduct Decrease in Unpaid, Deferred and Apportioned dividends	.....		
74.	**Decrease in Surplus on Dividend Account**			.....
	SPECIAL FUNDS			
75.	Special Funds and Special Reserves December 31, 1907	.....		
76.	Special Funds and Special Reserves December 31, 1908	.....		
77.	....**crease in Special Funds and Special Reserves during the year**	———	.....	.....
	PROFIT AND LOSS (EXCLUDING INVESTMENTS)			
78.	Carried to Profit Account	.....		
79.	Carried to Loss Account	.....		
80.	**Net to.....Account**		.....	.....

(FORM 33—Continued)

GAIN AND LOSS EXHIBIT—CONTINUED

INVESTMENT EXHIBIT

INVESTMENTS SOLD

			Gain in Surplus	Loss in Surplus
81.	Market Value December 31, of previous year of Real Estate sold during the year plus $.....Increase in Book Value of Improvements and Reduction of Incumbrances on said Real Estate during the year and which have not been entered in Disbursements.....	$.....		
82.	Received from Sale of said Real Estate.....	.....		
83.	*.....**from Sale of said Real Estate**.....		$.....	$.....
84.	Market Value December 31, of previous year of other Investments sold during the year.....	.....		
85.	Received from Sale of said Investments.....	.....		
86.	*.....**from Sale of said Investments**.....		.....	.....

INVESTMENTS PURCHASED

87.	Cost of Real Estate acquired during the year and owned December 31, 1908....	.....		
88.	Market Value of same December 31, 1908.....	.....		
89.	*.....**on said Real Estate**.....		.....	.....
90.	Cost of Investments, other than Real Estate, acquired during the year and owned December 31, 1908.....	.....		
91.	Market Value of same December 31, 1908.....	.....		
92.	*.....**on said Investments**.....		.....	.....
	Amounts carried forward		$.....	$.....

*Write "Gain" or "Loss".

GAIN AND LOSS EXHIBIT—Continued

			Gain in Surplus	Loss in Surplus
	Amounts brought forward,	$.....	$.....	$.....
	INVESTMENTS HELD			
93.	Market Value December 31, 1907, of Real Estate then owned and remaining unsold December 31, 1908, plus $..... increase in Book Value of improvements and Reduction of Incumbrances on said Real Estate during the year and which have not been entered in Disbursements.....	.....		
94.	Market Value December 31, 1908.....	.....		
95.	*.....on said Real Estate during the year.....		.....	.....
96.	Market Value December 31, 1907, of other Investments then owned and remaining Unsold December 31, 1908.....	.....		
97.	Market Value of same December 31, 1908.....	.....		
98.	*.....on said Investments during the year.....		.....	.....
99.	*.....on sale during the year of Real Estate acquired since December 31, 1907.....		.....	.....
100.	*.....on sale during the year of other Investments acquired since December 31, 1907.....		.....	.....
101.	*.....from Assets not admitted excepting item 40, page 4..			
	MISCELLANEOUS			
102.	*.....from all other sources (give items and amounts):		.....	.....
103.	*.....		.....	.....
104.	.....		.....	.....
105.	*.....unaccounted for.....		.....	.....
106.	Total Gains and Losses in Surplus during the year.....		$.....	$.....
	SURPLUS			
107.	Surplus December 31, 1907, per item 44, page 5, of the Annual Statement for said year.....	.....		
108.	Surplus December 31, 1908, per item 45, page 5.....	.....		
109.	.....crease in Surplus (enter in column to Balance).....	.....		.....
	TOTALS.....	.....	$.....	$.....

*Write "Gain" or "Loss."

(FORM 33—Concluded)

FORM PRESCRIBED BY THE ENGLISH COMPANIES ACT

BALANCE SHEET OF THE.....CO., MADE UP TO 19

PROPERTY AND ASSETS:

PROPERTY HELD BY COMPANY:

Showing:

Immovable Property, distinguishing:

	$	$
(a) Freehold Land.....		
(b) Freehold Buildings.....		
(c) Leasehold Buildings.....		

Movable Property, distinguishing:

(d) Stock-in-Trade		
(e) Plant.....		
The cost to be stated with deductions for deterioration in value as charged to the Reserve Fund or Profit and Loss.....		

DEBTS OWING TO THE COMPANY:

Showing:

Debts considered good for which the Company holds Bills or other Securities.....		
Debts considered good for which the Company holds no Security.....		
Debts considered doubtful and bad.....		
Any Debt Due from a Director or Other Officer of the Company to be separately stated.		

CASH AND INVESTMENTS:

Showing:

The nature of Investment and Rate of Interest.....		
The Amount of Cash, where Lodged, and if Bearing Interest.....		
	$	$

FORM PRESCRIBED BY THE ENGLISH COMPANIES ACT

BALANCE SHEET OF THE.....CO., MADE UP TO 19

CAPITAL AND LIABILITIES:

	$	$
Capital:		
Showing:		
The Number of Shares.....		
The Amount Paid per Share.....		
If any Arrears of Calls, the nature of the Arrears, and the Names of the Defaulters		
The Particulars of any Forfeited Shares.....		
Debts and Liabilities of the Company:		
Showing:		
The Amount of Loans on Mortgages or Debenture Bonds.....		
The Amount of Debts Owing by the Company distinguishing:		
(a) Debts for which Acceptances have been given.....		
(b) Debts to Tradesmen for Supplies of Stock-in-Trade or Other Articles.....		
(c) Debts for Law Expenses.....		
(d) Debts for Interest on Debentures or Other Loans.....		
(e) Unclaimed Dividends.....		
(f) Debts not enumerated above.....		
Reserve Fund:		
Showing:		
The Amount set aside from Profits to meet Contingencies.....		
Profit and Loss:		
Showing:		
The Disposable Balance for Payment of Dividends, etc.....		
	$	$
Contingent Liabilities:		
Claims Against the Company not Acknowledged as Debts.....		
Moneys for which the Company is Contingently Liable.....		

(Form 34—Concluded)

FORM SUGGESTED BY G. S. PITT TO SOCIETY OF INCORPORATED ACCOUNTANTS AND AUDITORS

BALANCE SHEET.....(date)

PROPERTIES AND ASSETS:

CASH AND BILLS:			
Bank	$.....		
Bills Receivable	.....	$.....	
INVESTMENTS:			
At Middle Market Price, viz.:			
British Government	$.....		
Colonies	.....	.....	
SUNDRY DEBTORS:			.....
Secured	$.....		
Unsecured			
Less: Reserve for Discount and Bad Debts	.....	.....	
STOCK:			
At Managers' Valuation		.....	
		$.....	
TOTAL LIQUID ASSETS	$.....		
PLANT at Cost			
Additions to 31st December, 1906	.....		
Additions During Year	.....		
	$.....		
Less: Amount Written Off to 31st December, 1906	$.....		
Amount Written Off During the Year	.....	.....	.....
PROPERTY:		$.....	
Freehold at Cost	$.....		
Leasehold at Cost			
Less: Written Off	.....	.....	.....
GOODWILL as at			.....
Accounts in Course of Extinction			
PRELIMINARY EXPENSES		$.....	
Less: Written Off		.....	.....
RATES AND TAXES Paid in Advance			.....
			$.....

(FORM 35)

FORM SUGGESTED BY G. S. PITT TO SOCIETY OF INCORPORATED ACCOUNTANTS AND AUDITORS

BALANCE SHEET.....(date)

CAPITAL AND LIABILITIES:

SUNDRY CREDITORS:		
Trade Creditors	$.....	
Sundry Creditors	.....	
		$.....
BILLS PAYABLE		.....
UNCLAIMED DIVIDENDS		.....
DEBENTURES (Due Date)		.....
TOTAL CASH LIABILITIES		$.....
CAPITAL:		
Authorized	$.....	
Subscribed in Cash	$.....	
Less: Calls in Arrears	.....	
Issued as Fully Paid		.....
FORFEITED SHARES ACCOUNT		.....
INVESTMENT RESERVE		.....
ORDINARY RESERVE		.....
PROFIT AND LOSS		.....
Contingent Liabilities, viz.:		$.....

(FORM 35—Concluded)

FORM RECOMMENDED BY SOCIETY OF INCORPORATED ACCOUNTANTS AND AUDITORS TO COMMITTEE OF PARLIAMENT

A. B. COMPANY LIMITED

BALANCE SHEET,.....(date).....

ASSETS:

FIXED ASSETS. Showing:—			
Freehold Property		$.....	
Leasehold Property	$.....		
Less Depreciation	.....		
		.....	
Plant and Machinery	$.....		
Less Depreciation	.....		
		.....	
Fixtures and Fittings	$.....		
Less Depreciation	.....		
		.....	
Goodwill		.....	
Other Fixed Assets (if any)		.....	
			$.....
FLOATING ASSETS. Showing:—			
Cash in Bank and in Hand		$.....	
Investment of Sinking Fund (if any)		.....	
Other Investments		.....	
Debts Due to the Company, Distinguishing—			
(a) Debts on Bills Receivable	$.....		
(b) Trade Debts on Open Accounts	.....		
(c) Other Debts	.....		
(Any Debt Due by an Officer of the Company to be Separately Stated)			
	$		
Deduct Reserve for Bad and Doubtful Debts	.....		
		.....	
Stock-in Trade		.....	
Other Floating Assets (if any)		.....	.....
NOMINAL ACCOUNTS. Showing:—			
Preliminary Expenses	$.....		
Less amount written off	.....		
		$.....	
Insurance, etc. Unexpired		.....	
Rents, Rates and Taxes, etc., Paid in Advance		.....	
Items in Suspense		.....	
Other Nominal Items (if any)		.....	
			.....
			$.....

(FORM 36)

FORM RECOMMENDED BY SOCIETY OF INCORPORATED ACCOUNTANTS AND AUDITORS TO COMMITTEE OF PARLIAMENT

A. B. COMPANY LIMITED

BALANCE SHEET,.....(date).....

LIABILITIES:

CAPITAL STOCK. Showing:—			
Preferred,			
Authorized, Shares at $.....each....	$.....		
Outstanding Shares at $.....each.....		$.....	
Common,			
Authorized, Shares at $.....each ..	$.....		
Outstanding Shares at $.....each ..		.....	
			$.....
LIABILITIES TO THE PUBLIC. Showing:—			
Specific Mortgages (if not Deducted per Contra).....	$.....		
Bonds.....	.....		
		$.....	
Debts owing by the Company, Distinguishing—			
(a) Bills Payable.....	$.....		
(b) Accounts Payable.....	.....		
(c) Interest on Bonds and Loans.....	.....		
(d) Unclaimed Dividends.....	.....		
(e) Other Debts	.....		
		.....	
BALANCE. Consisting of:—			
General Reserve, Including Bond Redemption, if any (Specific Reserves being deducted per Contra)		$.....	
Sinking Fund (if any).....		.....	
Forfeited Shares Account (if any).....		.....	
Undivided Profits.....		.....	
		.....	
			$.....

CONTINGENT LIABILITIES

Claims against the Company not Acknowledged as Debts, Moneys for which the Company is contingently liable.

(FORM 36—Concluded)

AMERICAN FORM IN GENERAL USE AMONG LARGE CORPORATIONS

MODEL MANUFACTURING COMPANY

BALANCE SHEET.....19...

ASSETS:

PROPERTY ACCOUNT:

Balance at.....19.. .....,		$.....	
Construction and Purchases of Additional Property During Year.....		.....	
		$.....	
Less Charged off to Following Accounts:			
		$.....	
Reserve for Depreciation.....	$.....		
	.....		
		.....	
			$.....
GOODWILL.....			.....

DEFERRED CHARGES TO OPERATIONS:

(Prepaid insurance Taxes, etc.; Advanced Mining Royalities and Similar Expenses Chargeable to Future Operations).....			.....

INVESTMENTS:

Outside Real Estate and Other Property.....		$.....	
Stocks of Other Companies.....		.....	
Bonds of Other Companies.....		.....	
			.....

CURRENT ASSETS:

Inventories.....		$.....	
Bills Receivable.....		.....	
Accounts Receivable.....		.....	
Cash.....		.....	
			.....

SINKING AND SPECIAL FUND ASSETS:

(State Nature of Assets and Funds for which held.....		$.....	
		.....	
			.....
			$.....

AMERICAN FORM IN GENERAL USE AMONG LARGE CORPORATIONS

MODEL MANUFACTURING COMPANY

BALANCE SHEET.....19...

LIABILITIES:

BONDED DEBT:

(State Nature, Rate of Interest and Due Date of Various Issues and Show Deduction of any Unsold Bonds)..... $.....

.....

$.....

CURRENT LIABILITIES:

Bills Payable..... $.....

Accounts Payable..... .....

Accrued Taxes..... .....

Accrued Interest..... W.....

Miscellaneous..... .....

.....

$.....

RESERVES AND SPECIAL FUNDS:

(State Purpose and Amount of Each Reserve or Fund.. .....

.....

.....

CAPITAL STOCK:
(If more than One Class State Accordingly..... $.....

*BOND SINKING FUND..... .....

SURPLUS, as Annexed..... .....

.....

$.....

*This is the proper place for the bond sinking fund only in the event of it having been set up by charges to profit and loss in addition to adequate provision for deprec iation of all wasting assets. If the sinking fund is permitted to take the place of a depreciation reserve it should be shown under "Reserves and Special Funds."

(FORM 37—Concluded)

AMERICAN FORM USED BY FIRMS AND INDIVIDUALS

BIRD & GUNN

BALANCE SHEET.....19

(FOR TRADING FIRM)

ASSETS:

Cash in Bank and on Hand		$.....
Bills Receivable		.....
Accounts Receivable		.....
Inventory of Merchandise (at cost)		.....
Unexpired Insurance		.....
Furniture and Fixtures		.....
		$.....

LIABILITIES:

Bills Payable	$.....	
Accounts Payable	.....	
Accrued Accounts (Wages, Interest, Etc.)	.....	
		.....

CAPITAL:

R. A. Bird, as annexed	$.....	
A. B. Gunn, as annexed	.....	
		.....
		$.....

(FORM 38)

PROFIT AND LOSS ACCOUNT

(APPROVED AMERICAN FORM)

Gross Earnings, (whether sales of products, transportation earnings, professional earnings, etc.)		$.....
Deduct: Cost of Manufacture or Operation:		
(a) Manufacture (for a Manufacturing Concern):		
Labor	$.....	
Material	.....	
General Manufacturing Expenses	.....	
(b) Cost of Operation (for Concerns not Manufacturing):		
(Under suitable headings according to the nature of the business)	.....	
		.....
Gross Profits		$.....
Other Earnings		.....
		$.....
Deduct:		
Expenses of sale (manufacturing business only)	$.....	
Expenses of management (if distinct from operation)	.....	
		.....
Net Profits from Operations		$.....
Deduct:		
Interest on Bonds	$.....	
Other Fixed Charges	.....	
		.....
Surplus for the year		$.....
Extraordinary Profits (detailed)		.....
Surplus brought forward from preceding year		.....
		$.....
Deduct:		
Extraordinary charges not applicable to operations of the year	$.....	
Interest and Dividends on Stocks	.....	
		.....
Surplus carried forward		$.....

(FORM 39)

PROFIT AND LOSS ACCOUNT

(FOR TRADING FIRM)

Gross Sales		$.....
Less: Returns and Allowances	$.....	
Discounts	.....	.....
Net Sales		$.....
Inventory (beginning of year)	$.....	
Purchases	.....	
	$.....	
Less: Inventory (end of year)	.....	
Cost of Sales		.....
Gross Profit		$.....
Selling and General Expenses (probably stated in some detail)		.....
Trading Profit		$.....
Interest (and other fixed charges not chargeable among selling expenses)		.....
Net Profit		$.....
Apportioned between Partners:		
R. A. Bird, ⅔	$.....	
A. B. Gunn, ⅓	.....	.....
		$.....

(FORM 40)

STANDARD FORM OF BORROWERS' STATEMENT

TO THE.....BANK:

For the purpose of procuring credit from time to time with you for our negotiable paper or otherwise, we furnish the following as a true and accurate statement of our financial condition on.....19....., which we may hereafter be considered as representing to be a true statement of our financial condition unless notice of change is given you.

ASSETS

CASH on hand and in bank				
NOTES RECEIVABLE of customers (not transferred)				
ACCOUNTS RECEIVABLE of customers (not transferred)				
NOTES AND ACCOUNTS RECEIVABLE of officers (not transferred)				
MERCHANDISE finished (how valued.....)				
" unfinished (how valued.....)				
" raw material (how valued.....)				
LAND owned by corporation, used for this business				
BUILDINGS owned by corporation, used for this business				
MACHINERY owned by corporation, used for this business				
.....				
.....				
.....				
TOTAL				

LIABILITIES

NOTES PAYABLE given for merchandise				
NOTES PAYABLE negotiated to own banks				
NOTES PAYABLE otherwise disposed of				
ACCOUNTS PAYABLE				
DEPOSITS OF MONEY WITH US				
.....				
.....				
BONDED DEBT (when due).....				
MORTGAGE DEBT.....				
CHATTEL MORTGAGES.....				
.....				
.....				
.....				
.....				
TOTAL LIABILITIES				
CAPITAL				
SURPLUS including UNDIVIDED PROFITS				
TOTAL				

(FORM 41)

CONTINGENT LIABILITY: NOTES RECEIVABLE of customers DISCOUNTED or SOLD and NOT included in assets enumerated above $.....

OTHER contingent liability.....$.....

WE HAVE NOT PLEDGED or ASSIGNED any of the ABOVE ACCOUNTS RECEIVABLE; our ASSIGNED ACCOUNTS RECEIVABLE amount to $.....

OTHER assets used as collateral.....

INSURANCE: on merchandise $.....buildings $.....

machinery $.....TOTAL INSURANCE

BUSINESS and RESULTS: ANNUAL SALES for the year ended .....190....

or from.....190....to.....190....

GROSS PROFITS on SALES	for the same period $.....
EXPENSE of CONDUCTING BUSINESS	" " " "
NET PROFIT	" " " "
OTHER INCOME including investments	" " " "
COMBINED PROFIT	" " " "

DIVIDENDS PAID for the period.....190....to.....190....$.....

BAD DEBTS for the period.....190....to.....190....$.....

CAPITAL: AUTHORIZED $.....ISSUED $.....

PAR VALUE $.....per share

BANK ACCOUNTS: where kept .....

MORTGAGES and BONDS on what assets a lien.....

Average TERMS on which we SELL.....

Average TERMS on which we BUY.....

TIME OF YEAR when NOTES and ACCOUNTS RECEIVABLE of CUSTOMERS, UNCOLLECTED, are generally maximum.....

minimum.....

TIME OF YEAR when STOCKS of MERCHANDISE on hand are generally maximum.....minimum.....

TIME OF YEAR when LIABILITIES are maximum.....

minimum.....

STATEMENT: is it based on actual inventory? .....

if so, DATE.....

VERIFICATION: have the books been audited by a CERTIFIED PUBLIC ACCOUNTANT?.....if so, NAME and DATE of AUDIT.....

(Sign corporation name)

.....

DATE SIGNED.....190....

(FORM 41—Concluded)

(MUNICIPAL REPORTS)

RECEIPTS CLASSIFIED BY CHARACTER AND SOURCE, AND BY DEPARTMENT, OFFICE, ENTERPRISE OR ACCOUNT

A. Receipts from Revenues and Accompanying Temporary Receipts

I. From General Revenues

(*a*) From Taxes

General Property Taxes for Government of City

1. For City Corporation
2. For Other Independent Divisions

For Other Civil Divisions

3. For State
4. For County
5. For Minor Civil Divisions

Special Property and Business Taxes

6. .....
7. .....
8. .....
9. .....
10. .....
11. .....
12. .....

Poll Taxes

13. For City Corporation
14. For Other Independent divisions of the Government of the City
15. For State
16. For minor Civil Divisions
17. Total Taxes .....

B. From Taxes, Licenses, Permits, Fines, and Forfeits

18. Total Taxes
19. Liquor Licenses and Other Imposts
20. Other Business Licenses
21. Dog Licenses
22. General Licenses
23. Departmental Permits
24. Fines and Forfeits:
    a. Penal
    b. Commercial
25. Total Taxes, Licenses, Permits, Fines, and Forfeits.....

(Form 42)

A. Receipts from Revenues and Accompanying Temporary Receipts—Continued

I. From General Revenues—Continued

(c) From Gifts, Subventions, Grants, and Miscellaneous General Revenues

26. Subventions and Grants from Other Civil Divisions:
    - *a.* From State, for Education
    - *b.* From State, for Other Purposes
    - *c.* From County, for Education
    - *d.* From County, for Other Purposes
    - *e.* Other Governmental Grants

27. Gifts from Individuals and Corporations:
    - *a.* For Expenses
    - *b.* For Outlays

28. Miscellaneous General Revenues:
    - *a.* .....
    - *b.* .....

29. Total General Revenue Receipts.....

II. From Commercial Revenues

(d) From Special Assessments and Privileges

30. Special Assessments:
    - *a.* For Expense
    - *b.* For Outlays
    - *c.* For Other Civil Divisions

31. Public Service Privileges

32. Minor Privileges

33. Total Special Assessments and Privileges.....

(e). From Interest

34. Interest:
    - *a.* Sinking Funds
    - *b.* Investment Funds
    - *c.* Public Trust Funds
    - *d.* Original Loans
    - *e.* Current Deposits
    - *f.* Deferred Taxes
    - *g.* Deferred Special Assessments
    - *h.* Other Sources
    - *i.* Total Interest Receipts.....

A. Receipts from Revenues and Accompanying Temporary Receipts—Continued

II. From Commercial Revenues—Continued

(*f*) From Municipal Services by Departments, Offices, or Accounts

I. General Government

35. Council and Legislative Offices
36. Chief Executive Offices
37. Assessment and Collection of Revenues
38. Other Finance Offices and Accounts
39. Law Offices
40. Miscellaneous Executive Offices
41. Elections
42. Municipal Buildings
43. Courts
44. Total General Government.....

II. Protection of Life and Property

45. Police Department
46. Fire Department
47. Miscellaneous Inspection
48. Pounds
49. Other Protection of Life and Property
50. Total Protection of Life and Property .....

III. Health Conservation and Sanitation

51. Health Department, Quarantine, and Morgue
52. Sewers and Sewage Disposal
53. Street Cleaning
54. Refuse Disposal and Other Sanitation
55. Total Health Conservation and Sanitation .....

IV. Highways

56. General Supervision
57. General Street Services
58. Sidewalks
59. Bridges, Other Than Toll
60. Abolition of Grade Crossings
61. Snow and Ice Removal
62. Street Lighting
63. Street Sprinkling
64. Miscellaneous
65. Total Highways .....

(Form 42—Continued)

A. Receipts from Revenues and Accompanying Temporary Receipts—Continued

II. From Commercial Revenues—Continued

(*f*) From Municipal Services by Departments, Offices, or Accounts—Continued

V. Charities and Corrections

66. General Supervision
67. Poor in Institutions
68. Outdoor poor Relief
69. Care of Children
70. Miscellaneous Charities
71. Hospitals
72. Insane in Institutions
73. Prisons and Reformatories
74. Total Charities and Corrections.....

VI. Education

75. Schools
76. Libraries
77. Art Galleries and Museums
78. Total Education.....

VII. Recreation

79. Parks, gardens, etc
80. Baths, Bathing Beaches, etc.
81. Celebrations and Entertainments
82. Total Recreation.....

VIII. Miscellaneous Services

83. Miscellaneous Services
84. Total from Municipal Services.....

(*g*) From Municipal Service Enterprises

85. Electric light svstems
86. .....
87. .....
88. .....
89. .....
90. Total Municipal Service Enterprises.....

(Form 42—Continued)

A. Receipts from Revenues and Accompanying Temporary Receipts—Continued

II From Commercial Revenues—Continued

(*h*) From Public Service Enterprises

91. Water Supply Systems
92. Electric Light Systems
93. Gas Supply Systems
94. Markets and Public Scales
95. Docks, Wharves and Landings
96. Subways for Pipes and Wires
97. Ferries
98. Toll Bridges
99. Cemetaries and Crematories
100. Institutional Industries
101. .....
102. .....
103. .....
104. Total Public Service Enterprises.....
Total Receipts from Revenue and Accompanying Temporary Receipts.....

B. Receipts from Municipal Debt Obligations Issued

105. *a.* General bonds
b. Special Debt Obligations to Public Trust Funds
c. Debt Obligations to Other Civil Divisions
d. Special Assessment Bonds
e. Revenue Loans
f. Outstanding Warrants and Orders
g. Outstanding judgments
h. Miscellaneous Debt Obligations
i. Total Receipts from Dept Obligations Issued.

C. Miscellaneous Temporary Receipts

106. Objects of Public Trust Funds for Non-municipal uses
107. Objects of Private Trust Funds
108. Objects of Private Trust Accounts
109. From Investments Disposed of:
a. By Sinking Funds
b. By Investment Funds
c. By Public Trust Funds for Municipal Uses
d. By Public Trust Funds for Non-municipal Uses
e. By Private Trust Funds
110. Sales of Real Property
111. Damages to City Property

C. Miscellaneous Temporary Receipts—Continued

112. Refund Receipts in Correction of Erroneous Payments:
   a. In Expenses, P. 1 to P. 72
   b. In Outlays, P. 1 to P. 72
   c. In Expenses of Public Service Enterprises
   d. In Outlays of Public Service Enterprises
   e. In Conscience Money
   f. In Losses by Defalcation, etc.

113. Total Temporary Receipts.....

D. Miscellaneous Accounting Credits

114. Cash Transfer Receipts of Independent Divisions and Funds:
   a. By City Corporation.....from Sinking Funds.....
   b. By .....from .....
   c. By .....from .....
   d. By .....from .....
   e. By .....from .....
   f. By .....from .....

115. Depreciation Service Transfers

116. Minor Transfer Receipts

117. Other Accounting Credits

118. Total Receipts and Accounting Credits.....

(Form 42—Continued)

(MUNICIPAL REPORTS)

PAYMENTS CLASSIFIED BY DEPARTMENT, OFFICE, ENTERPRISE, OR ACCOUNT, AND BY OBJECT FOR WHICH MADE

A. Payments for Expenses and Outlays

I. General Government

1. Council and Legislative Offices:
   - *a.* Council, Board of Aldermen, etc.
   - *b.* City Clerk
2. Chief Executive Offices:
   - *a.* Mayor's Office
   - *b.* Executive Boards and Commissions
3. Finance Offices and Accounts:
   - *a.* Auditor, or Comptroller
   - *b.* Treasurer, or Chamberlain
   - *c.* Assessment of Revenue
   - *d.* Collection of Revenue
   - *e.* Other Finance Offices and Accounts
4. Law Offices
5. Miscellaneous Executive Offices:
   - *a.* Boards of Public Service
   - *b.* City Engineer
   - *c.* .....
   - *d.* .....
   - *e.* .....
6. Elections
7. Municipal Buildings
8. Courts and Court Officers:
   - *a.* General Municipal Courts
   - *b.* Special Municipal Courts
   - *c.* Superior Courts
   - *d.* Court Buildings
   - *e.* Prosecuting Officers
   - *f.* Marshals and Sheriffs
9. Total General Government.....

II. Protection of Life and Property

10. Police Department:
    - *a.* General Expenditures
    - *b.* Pensions and Gratuities
11. Militia and Armories
12. Fire Department:
    - *a.* General Expenditures
    - *b.* Pensions and Gratuities
    - *c.* Water

(Form 42—Continued)

A. Payments for Expenses and Outlays—Continued

II. Protection of Life and Property—Continued

13. Miscellaneous Inspection
14. Pounds
15. Miscellaneous
    a. .....
    b. .....
    c. .....
    d. .....
16. Total Protection of Life and Property.....

III. Health Conservation and Sanitation

Health Conservation

17. Health Department:
    a. General Expenditures
    b. Pensions and Gratuities
18. Quarantine and Contageous Disease Hospitals
19. Morgues

Sanitation

20. Sewers and Sewage Disposal:
    a. Supervision
    b. General Expenditures
21. Street Cleaning
22. Refuse Disposal
23. Miscellaneous:
    a. .....
    b. .....
24. Total Health Conservation and Sanitation.....

IV. Highways

25. General Supervision
26. General Street Expenditures
27. Street Pavements:
    a. General Expenditures
    b. Renewals
28. Street Curbing
29. Sidewalks
30. Bridges Other Than Toll
31. Abolition of Grade Crossings

A. Payments for Expenses and Outlays—Continued

IV. Highways—Continued.

32. Snow and Ice Removal
33. Street Lighting
34. Street Sprinkling
35. Miscellaneous
    a.....
    b.....
36. Total Highways.....

V. Charities and Corrections

37. General Supervision
38. Poor in Institutions:
    a Of City
    b. Of Other Civil Divisions
    c. Of Private Associations
39. Outdoor Poor Relief:
    a. In City (direct)
    b. By Other Civil Divisions
    c. By Private Associations
40. Care of Children:
    a. In City Institutions
    b. In Institutions of Other Civil Divisions
    c. In Private Institutions
    d. In Private Families
41. Miscellaneous Charities:
    a. Employment Agencies
    b. Soldiers' Relief
    c. .....
    d. .....
    e. .....
    f. .....
    g. .....
42. Hospitals:
    a. Of City
    b. Of Other Civil Divisions
    c. Of Private Associations
43. Insane in Institutions:
    a. Of City
    b. Of Other Civil Divisions
    c. Of Private Associations
44. Prisons and Reformatories:
    a. Of City
    b. Of Other Civil Divisions
    c. Of Private Associations
45. Total Charities and Corrections.....

A. Payments for Expenses and Outlays—Continued

VI. Education

Schools

46. General Supervision

47. Elementary Day Schools:
   a. General Expenditures
   b. Teaching

48. Day Schools for Higher Education:
   a. General Expenditures
   b. Teaching

49. Night Schools:
   a. General Expenditures
   b. Teaching

50. Schools for Special Classes:
   a. General Expenditures
   b. Teaching

51. Pensions and Gratuities

52. Schools of Other Civil Divisions

53. Private Schools

54. Total Schools.....

55. Libraries

56. Art Galleries and Museums

57. Total Education.....

VII. Recreation

58. Parks, Gardens, etc.:
   a. General Supervision
   b. Buildings and Grounds
   c. Park Police
   d. Zoological Collections
   e. Public Playgrounds
   f. Music in Parks
   g. Trees in Streets

59. Total Parks, Gardens, etc.....

60. Baths, Bathing Beaches, etc.

61. Celebrations and Entertainments

62. Miscellaneous:
   a. .....
   b. .....
   c. .....

63. Total Recreation.....

(Form 42—Continued)

A. Payments for Expenses and Outlays—Continued

VIII. Miscellaneous

64. Miscellaneous Offices:
    a. .....
    b. .....
    c. .....

65. Miscellaneous Objects:
    a. Damage Settlements and Judgments
    b. Losses by Defalcation, Banks, etc.
    c. .....
    d. .....
    e. .....

66. Total Miscellaneous.....

67. Total Divisions I to VIII.....

IX. Municipal Service Enterprises

68. Electric Light Systems

69. .....

70. .....

71. .....

72. .....

73. Total Municipal Service Enterprises..

X. Public Service Enterprises

74. Water Supply Systems

75. Electric Light Systems

76. Gas Supply Systems

77. Markets and Public Scales

78. Docks, Wharves, and Landings

79. Subways for Pipes and Wires

80. Ferries

81. Toll Bridges

82. Cemeteries and Crematories

83. Institutional Industries

84. .....

85. .....

86. Total Public Service Enterprises.....

A. Payments for Expenses and Outlays—Continued

XI. Expenses of Invested Funds

87. Expenses of Invested Funds
88. Total Divisions IX to XI.....

XII. Interest

89. *a.* On Debts for General Purposes
b. On Debts for Public Service Enterprises
c. On Debts of Invested Funds
d. On Debts for Local Improvements (Special Assessments)
e. On Outlay Accounts
f. Total Interest Payments.....
90. Total Payments for Expenses and Outlays.....

B. Payments of Municipal Debt Obligations

91. *a.* General Bonds
b. Special Debt Obligations to Public Trust Funds
c. Debt Obligations to Other Civil Divisions
d. Special Assessment Bonds
e. Revenue Loans
f. Outstanding Warrants and Orders
g. Outstanding Judgments
h. Miscellaneous Debt Obligations
i. Total Payments of Debt Obligations.....

C. Miscellaneous Temporary Payments

92. Objects of Public Trust Funds for Non-municipal Uses
93. Objects of Private Trust Funds .....
94. Objects of Private Trust Accounts.....
95. For Investments purchased:
a. By Sinking Funds
b. By Investment Funds
c. By Public Trust Funds for Municipal Uses
d. By Public Trust Funds for Non-municipal Uses
e. By Private Trust Funds

(Form 42—Continued)

C. Miscellaneous Temporary Payments—Continued

96. Refund Payments in Correction of Erroneous Receipts:
   a. In Subdivisions (*a*), (*b*), (*c*), (*d*) and (*e*) of Revenue Receipts
   b. In Subdivision (f) and (g) of Revenue Receipts
   c. In Subdivision (*h*) of Revenue Receipts
   d. In Unspecified Receipts

97. Payments to Other Civil Divisions:
   a. To State, for Taxes ....$..... On Other Accounts $.....
   b. To Counties, for Taxes..... On Other Accounts .....
   c. To Minor Civil Divisions
   for Taxes..... On Other Accounts .....

98. Total Miscellaneous Temporary Payments $.....

D. Miscellaneous Accounting Debits

99. Cash Transfer Payments by Independent Divisions and Funds:
   a. By City Corporation..... To Sinking Funds.....
   b. By..... To.....
   c. By..... To.....
   d. By..... To.....
   e. By..... To.....
   f. By..... To.....

100. Minor Transfer Payments.....

101. Other Accounting Debits.....

102. Total Payments and Accounting Debits .....

(Form 42—Concluded)

APPENDIX E.

C. P. A. Examination Questions.

Since the first certified public accountant law—that of the State of New York—was enacted in 1896, many states, particularly those in which the larger cities of the country are located, have followed suit.

At this writing there are nineteen states which have passed C. P. A. laws. These, with the year in which the law was enacted, are:

1896 New York
1899 Pennsylvania
1900 Maryland
1901 California
1903 Washington
1903 Illinois
1904 New Jersey
1905 Michigan
1905 Florida
1906 Rhode Island
1907 Utah
1907 Colorado
1907 Connecticut
1908 Ohio
1908 Louisiana
1908 Georgia
1909 Massachusetts
1909 Minnesota
1909 Montana

The laws in all the states excepting New York, Pennsylvania, Maryland, New Jersey and Massachusetts specify theory of accounts, practical accounting, auditing* and commercial law as subjects on which candidates shall be examined, and the model C. P. A. law submitted by the Committee on Legislation at the 1907 annual meeting of the American Association of Public Accountants likewise names these four topics as the subject of examination of applicants for certificates.

There has been considerable discussion as to the desirability of continuing examinations under these headings, and one

*The Colorado law specifies only theoretical and practical accounting and commercial law, auditing not being specifically mentioned, though it would come within the scope of the phrase "such other subjects as the Board may deem advisable." This phrase also appears in the laws of some other states.

examining board—that of Pennsylvania—now groups the subjects of examination under two general headings, viz., "Commercial Law" and "General Accounting," the latter covering the ground, formerly divided among Theory of Accounts, Practical Accounting and Auditing. These subjects are interrelated to such an extent that it is difficult to frame questions on any one of them which do not overlap and the innovation of the Pennsylvania board has met with general approval. It has the further advantage of enabling the examining board to designedly frame questions which combine all three of the subjects in one question, which is more in accord with actual facts and practical experience. The rules of the Pennsylvania State Board of Examiners of Public Accountants which have been in effect since January 1, 1907, are probably the most complete and set the highest standard of any yet promulgated. Those desirous of becoming certified public accountants, no matter in what state they expect to take their examinations, will do well to study these rules (published in full in the January, 1907, *Journal of Accountancy*) as they outline in a comprehensive way the qualifications which the aspirant to a C.P.A. certificate should strive to acquire.

To what extent the fact that the laws of those states, which specify that candidates shall be examined in theory of accounts, practical accounting and auditing would interfere with the examiners in those states following the example of the Pennsylvania board, the editor, of course, does not pretend to say. It is thought, however, that this part of the examination could be stated as being on "General Accounting, Embracing the Subjects of Theory of Accounts, Practical Accounting and Auditing."

The necessity for a broader general education and more scientific preparation for a professional career, as distinguished from the narrow technical accomplishments which were at first, when accompanied by a good moral character, considered sufficient to entitle the applicant to practice as a certified public accountant, is now recognized. It should be said to the credit of

New York that it early recognized the importance of a good general education and required the equivalent of a high school education. Some of the later laws include such a requirement, while in still other cases the examining boards are making it a prerequisite to taking the technical examinations.

Future development along the line of testing the qualifications of applicants for C.P.A. certificates will doubtless result in the division of the examination into two sections, a preliminary and a final. This step has already been taken by the Pennsylvania board, which subjects the candidates to a

> Preliminary Examination "intended as a test of the candidates' general fitness for the study of accountancy." In the absence of having had a general education of high school grade, the applicant is examined on the subjects found in a high school curriculum; and all candidates are examined in the "History of Accountancy" and "Elementary Principles of Accounts,"

and a

> Final Examination, in "Commercial Law," and "General Accounting," to which reference has already been made.

The question of an experience requirement for applicants for certificates is also receiving much attention and consideration. It is becoming recognized that it is essential that one must have had some experience in the practical application of the theory he has studied or been taught in schools before he can really be qualified to hold himself out to the public as one who on examination by the proper authorities has been skilled in the practice of accountancy. Some of the examining boards have already prescribed an experience requirement and, without doubt, it will in time become general.

Included in this appendix are the questions on "Auditing" submitted at recent examinations in a number of different states. These give a fair idea of the scope of the subject of

this work from the viewpoint of the examining boards. The Pennsylvania questions are on "General Accounting" and include questions which are not strictly on auditing, but they are given in full that the superiority of this manner of treatment may be seen by those studying the questions.

PENNSYLVANIA.

Examinations held November 23 and 24, 1908.

(1) State the more important points of the national banking system relating to the formation of banks, responsibilities of directors and the general requirements as to the scope and conduct of the business.

(2) The Safe Trust Company has the following departments:

Banking,
Corporate Trust,
Individual Trust,
Registration and Transfer
Safe Deposit.

(1) Describe the various classes of business conducted in (a) the Corporate Trust Department and (b) the Individual Trust Department.

(2) Outline the accounting system you would recommend for the business of these two departments (assuming that the gross assets in each were $75,000,000 and $30,000,000 respectively) and describe the principal books you think should be used.

(3) Prepare a balance sheet as of September 30, 1908, for these two departments, showing captions, but omitting amounts.

(3) Describes the functions and method of operation of a stock exchange clearing house, and points out the differences

between a stock exchange clearing house and a bank clearing house.

(4) In auditing the accounts of a firm of stockbrokers how would you verify the accounts relating to bonds, stocks or other securities owned by the firm or carried for account of customers or others.

(5) You are asked to audit the accounts of the Universal Fire Insurance Company at December 31, 1908, and furnish a certificate to be published in connection with the balance sheet of the company. To what matters more or less peculiar to a fire insurance company should your attention be directed and how would you deal with each one?

(6) The Valley Manufacturing Company operates an extensive machine shop in the manufacture of sewing machines of which they produce a number of types. From time to time the company, through improvements designed in its experimental department, is able to produce new types of sewing machines or parts thereof. In bringing out a new type it is first necessary to make or buy a quantity of new machine tools, such as jigs, dies, etc., at a cost of say $5,000. These new types of sewing machines are brought out at irregular intervals averaging perhaps eighteen months apart. The machine shop contains a large variety of machines ranging in cost from $150 each to $2,500 each. In addition to its sales of completed machines the company sells large quantities of parts for purposes of repairs.

You are retained to devise and instal a system of cost accounts that will show as accurately as possible the cost not only of a complete sewing machine, but also of each one of its component parts.

Omitting a description of the portions of your cost system relative to materials and productive labor, explain how you would deal with (a) the problem of ascertaining the costs of individual parts, (b) the ascertainment and distribution of the

general expenses of the factory frequently known as the "shop burden," and (c) the disposition to be made of the cost of special jigs, dies and other machine tools acquired for the production of improved types of sewing machines or parts thereof.

(7) Form a trial balance of a manufacturing concern, either corporation, partnership, or individual, with which you are acquainted, and prepare therefrom a statement giving the results of operation, and a final balance sheet. Write a report dealing with the conditions of the business and commenting on the managerial results, volume of expenses, etc.

(8) By the partnership deed of a manufacturing firm consisting of four members, A., B., C., and D., it was provided that in the event of the death of any partner before the expiration of the partnership on December 31, 1909, there should be paid to the legal representatives of the deceased partner the amount appearing to his credit on December 31, next preceding the death, together with interest thereon at 5 per cent. per annum, to December 31 following the date of decease, and a share of the profits of the year of his decease corresponding to the number of days that he lived during it, calculated after the rate of the average of his share for the last three completed years. The four partners shared profits equally, and each took interest on his capital at 5 per cent. per annum, but no interest was charged on the drawings. The surviving partners were to share the profits equally. C. died on June 30, 1907. The profits of the three immediately preceding years had been respectively $70,000, $78,000 and $65,000. From the following trial balance of December 31, 1907, prepare manufacturing and profit and loss accounts for 1907, allowing $2,500 for depreciation of plant, and $250 for depreciation of office fixtures and furniture. Also construct a balance sheet showing the interest of the remaining partners and treating the amount owing to the estate of C. as a liability of the firm. In preparing this balance sheet follow the form you prefer and group the items in accordance with your best judgment.

TRIAL BALANCE—December 31, 1907.

A, Capital Account	No change in partners' capital accounts during year 1907.	$120,000.00
B, " "		110,000.00
C, " "		100,000.00
D, " "		90,000.00
A, Drawing Account	$12,000.00	
B, " "	12,000.00	
C, " "	5,000.00	
D, " "	12,000.00	
Stock December 31, 1906	$100,000.00	
(Note: Stock at December 31, 1907 was $125,000.00)		
Purchases during Year	$1,775,000.00	
Factory Wages and Salaries	250,000.00	
Discount received and allowed, balance of		20,000.00
Sales during the year		2,110,000.00
Cash in hand and at bank	29,500.00	
Bad Debts	16,000.00	
Bills Receivable in hand	15,000.00	
Office Salaries	9,000.00	
Office Expenses, General	2,500.00	
Sundry Debtors	414,000.00	
Traveling Expenses	10,000.00	
Insurance	1,000.00	
Office Rent, Taxes, etc	2,000.00	
Real Estate—Factory	60,000.00	
Factory Plant	15,000.00	
Office Fixtures and Furniture	2,500.00	
Bills Payable		50,000.00
Sundry Creditors on Open Accounts		150,000.00
Interest paid	7,500.00	
	$2,750,000.00	$2,750,000.00

(9) You are retained by an industrial company to make such an examination of its accounts as will enable you to certify to its balance sheet at December 31, 1908, the object of the company being to aid it in selling its notes through note brokers.

Give an outline of your method of procedure, showing the extent to which you would consider it necessary to carry your examination in respect to the several classes of assets and liabilities.

Assuming that you are satisfied to give a certificate to the balance sheet, in what form would you express it?

(10) A coal mining company "A," desires to acquire another smaller mining corporation "B,' the capital stock of which is $100,000. It purchases the entire capital stock for $300,000, and in order to obtain the funds, borrows that amount, giving five notes due in one, two, three, four and five years, for $60,000 each, and bearing interest at the rate of 6 per cent. per annum.

Company "B" owns no real estate, but operates under a lease which will expire fifteen years after the date of the above mentioned purchase. At the termination of the lease, all permanent improvements, buildings, etc., other than movable equipment, becomes the property of the lessor.

At the time of the purchase it is found that the current or liquid assets of company "B," other than the investment in buildings and equipment, amount to $50,000. It is also necessary to expend $10,000 per annum for the first two years in the erection of permanent buildings in addition to the ordinary charges for maintenance.

It is required that the stock of company "B" shall be worth par at the termination of the lease. It is further desired that interest on the notes given by "A" should be extinguished by the income received from "B," and also that the investment of "A," except as represented by the par value of the stock of company "B" should be extinguished before the termination of the lease.

Both companies are to be operated entirely independently of each other and the only connection is through that of stock ownership.

The reply to this question should be in the nature of a clear and concise plan, stating how these transactions should be treated on the books of both companies. Include with this a set of ledger accounts illustrating the workings of the plan you would recommend.

(11) A book publishing company has brought out its first book. Plates capable of 100,000 impressions cost $20,000; composition, proof reading, etc., cost $6,000; the author is to receive a royalty of 25 cents per volume on the books sold. As a first edition, 20,000 books are printed at a labor cost of $2,000, and a further charge of $1,500 to cover the proportion of general expenses. At the end of the year 10,000 copies had been sold for $20,000. How would you prepare the accounts under the following conditions?

(1) If it were ascertained that the demand for the book had practically ceased.

(2) If a steady demand would continue until the plates were worn out.

(12) The B. & E. Company is a wholesale trading concern, having its headquarters in Lancaster, Pa., and maintaining branch stores in a number of cities, Richmond, Va., among others. These branch stores receive their goods upon consignment from the head office; keep the accounts with their customers; make collections thereon; keep local bank accounts; pay current expense bills and remit their excess funds from time to time to the head office. The manager of the Richmond branch is employed on a small, fixed salary, and a commission based on the sales, the latter compensation being forwarded to him quarterly by check from the Lancaster office. Without intending to steal he adopted the habit of anticipating the arrival of his check and withheld collections received from customers, making no entries therefor upon the books for the time being, but being careful, however, not to hold out any one item longer than a few days, thus constantly replacing out of the current receipts items previously withheld. Upon receipt of his quarterly check for commissions he would at once make good the amount he had in the above manner advanced from the company's funds to himself.

(a) If you were instructed to audit the accounts of the B. & E. Company, including those of the branch offices, would your audit disclose this condition, and, if so, concisely and carefully describe the course you would pursue.

(b) What criticisms have you to offer relative to the administrative plan of the B. & E. Company as outlined above?

(c) Describe clearly the form of accounts you think is best adapted to this business if it were operated in accordance with the methods best suited in your judgment for the management of a business maintaining branch stores.

(13) A wool merchant has entered into an agreement to take 1,000,000 pounds of wool, in the grease, on joint account with the shipper, to have it washed, scoured, combed, etc., and sell the product; the profit or loss to be shared equally.

The grease wool is sent to the scourer in lots as received from the shipper and returned from day to day in smaller quantities as grades A B, C, D and E; these lots (or some of them) and combinations of said lots are sent to combers and again returned in smaller quantities from day to day as grades Nos. 1, 2, 3, 4, and 5.

The wool may be sold in any form that is in the grease, as grade, A, B, C, D, and E, or as grades Nos. 1, 2, 3, 4 and 5.

It will be necessary for the merchant to report the results of the transactions in each lot separately.

Submit a method for keeping a record of this stock and accounts from which proper statements can be made to the shipper showing the loss in the various processes, the quantities sold, to whom, prices, etc., and the net loss or gain.

(14) What are the present requirements of the Interstate Commerce Commission relative to the treatment of depreciation in the accounts and reports of railroad companies?

(15) Three railway lines, "A" Ry. Co., "B" Ry. Co., and "C" Ry. Co., all of the stocks of which are owned by a holding company, enter into an agreement of consolidation and merger under the name of the C. Ry. Co. New stock is issued to the holding company in exchange for the old stock, on a basis of share for share. And it is further agreed that sufficient additional new stock shall be issued and sold at par to the holding company for the purpose of redeeming the bonds of "A" and "C" and paying the interest accrued.

Following are balance sheets of the three companies. Accept values as stated and prepare a balance sheet of the consolidated company after all transactions incident to the merger are completed. In setting up the balance sheet do so with a view to the fact that none of the companies have made very liberal provision for the depreciation of their road and equipment.

BALANCE SHEET —"A" RAILWAY CO.

ASSETS.

Road and Equipment	$600,000.00	
Material and Supplies	5,000.00	
Accounts Receivable	2,000.00	
Bills Receivable owing from "B" Rwy. Co.	15,000.00	
Bills Receivable owing from "C" Rwy. Co.	2,000.00	
Cash	1,000.00	
Cash and Bonds in hands of Trustee of Sinking Fund for 1st Mortgage Bonds	30,000.00	
Total Assets		$655,000.00

LIABILITIES.

Capital Stock	$300,000.00	
First Mortgage Bonds	250,000.00	
Accounts Payable	10,000.00	
Sinking Fund—First Mortgage Bonds	30,000.00	
Accrued Interest on Bonds	6,250.00	
Profit and Loss	58,750.00	
Total Liabilities		$655,000.00

BALANCE SHEET—"B" RAILWAY CO.

ASSETS.

Road and Equipment	$250,000.00	
Material and Supplies	1,000.00	
Accounts Receivable	1,000.00	
Cash	1,000.00	
Profit and Loss	62,000.00	
Total Assets		$315,000.00

LIABILITIES.

Capital Stock	$300,000.00	
Bills Payable	15,000.00	
Total Liabilities		$315,000.00

BALANCE SHEET—"C" RAILWAY CO.

ASSETS.

Road and Equipment	$1,500,000.00	
Material and Supplies	10,000.00	
Accounts Receivable	10,000.00	
Cash	15,000.00	
Cash and Bonds in hands of Trustee of Sinking Fund for 1st Mtge Bonds	100,000.00	
Total Assets		$1,635,000.00

LIABILITIES.

Capital Stock	$1,000,000.00	
First Mortgage Bonds	500,000.00	
Bills Payable	2,000.00	
Sinking Fund 1st Mortgage Bonds	100,000.00	
Accrued Interest on Bonds	12,500.00	
Profit and Loss	20,500.00	
Total Liabilities		$1,635,000.00

(16) In municipal affairs what is the purpose of a budget? What relation does it bear to the accounting of a municipality?

(17) Make out for an intending purchaser a report of an examination made by you of a gas company, street railway

or electric lighting company, whichever you are most familiar with, covering in your report all points relating to the property and the accounts which are necessary for an intending purchaser to know, including not only matters divulged by your examination, but referring briefly to the contents of reports made by other experts upon examinations made by them at or about the same time as your own, but dealing with affairs outside the field of accounting.

(18) You are instructed by the receiver of an importing and trading concern to examine the accounts and report to him upon

(a) the financial position of the concern, and

(b) the causes that have mainly contributed to the failure.

In your answer prepare a statement of the assets and liabilities in such form as you think should be used for the information of the receiver and the creditors and under (b) state the matters to which you would direct your attention, having in mind the nature of the business, and how you would proceed with your investigation.

NEW YORK.

Examination held June 24, 1908.

(1) In the preparation of a manufacturing and trading account and a balance sheet, state on what basis the following assets should be valued:

(a) Raw materials.
(b) Product in process of manufacture.
(c) Manufactured product.
(d) Bills receivable.
(e) Accounts receivable.

Give fully your reasons.

(2) In preparing a statement of the earnings of a business, covering a period of five years, how, in order to determine what the average earning capacity of said business has been, should the expenditure for interest paid on bills payable and loans, and on accounts payable be considered?

(3) An examination of the minutes and other records of the books of a corporation, preceding an audit, discloses that a revaluation of its buildings, plant, and machinery, had been made by expert appraisers called in for the purpose. The report of these appraisers states that the values as determined by them were greater than those shown on the books. Should such increased value be entered on the books of the corporation? What entries should be made to show this in the profit and loss account and balance sheet?

(4) What kind of expenditures of a manufacturing business would you classify as being in the nature of maintenance and repairs of equipment, machinery, and plant, and what would constitute actual betterments? How should such expenditures be dealt with on the books and shown in the profit and loss statement, and on the balance sheet?

(5) Define and differentiate an audit conducted for the purpose of reviewing past transactions and establishing the significance thereof and an audit precedent to determining the verity of a bill or of a claim. Give a brief outline of the procedure in each case.

(6) State (a) for what class of assets provision for depreciation should be made, (b) what would constitute an adequate rate for depreciation on buildings and on plant and machinery respectively. Give reasons.

(7) How should a leasehold be treated in the accounts of a company, and how should it be shown on the balance sheet?

(8) Give a brief description of the books of a corporation that should be examined and inspected by the auditor, and state

the reasons why such examination or inspection should be made.

(9) What is the value of a bank pass-book for the purpose of an audit? How would you reconcile the pass-book balance with the cash book balance?

(10) In auditing an account the auditor finds that Robert Brown had bought a bill of goods amounting to $500 payable on August 10, less 2 per cent. He had, however, made payments thereon as follows:

June 2	$100
June 15	100
July 3	100

On what date would he be required to make payment of the remaining $200 to entitle him to the 2 per cent. discount under the original terms of sale?

(11) What generally constitutes capital expenditure? What expenditures are properly chargeable against revenue? Explain and give illustrations in each case.

(12) The accounts of a steel and iron manufacturing company show large additions to plant and machinery. It is found that these charges include considerable amounts from pay-rolls. In the absence of specific explanations as to the pay-roll element, what method should be employed by the auditor to determine the accuracy and the propriety of these charges?

(13) If the auditor has not verified or had opportunity to verify the actual cash on hand at the date of the balance sheet what should be his procedure to prove the correctness of the balance sheet as stated, before giving his certificate?

(14) In auditing the accounts of a railway company how should the auditor determine whether or not the net earnings are correctly stated?

(15) What test of the prime cost of manufactured goods should be made to guard against loss of raw material through theft by employees?

ILLINOIS.

Examination held May 4, 1908.

(1) In a case where preferred shares of a company are issued under a provision that the annual dividends to which they shall be entitled shall be "cumulative," would you consider it necessary to show any arrears of dividend as a liability upon the balance sheet, or how would you deal with it?

(2) What special points in the balance sheet of a company, aside from the correctness of the figures require careful consideration by the auditor?

(3) In making an audit of the accounts of a corporation, would you consider it part of your duty to verify the transfers of the certificates of capital stock occurring during the period covered by your examination?

(4) In financing a manufacturing company it is considered necessary to arrange for an issue of $300,000 first mortgage 5 per cent. 20-year bonds; $500,000 6 per cent. non-cumulative preferred stock, which may be retired any time after five years, and $1,000,000 common stock. The bonds are disposed of at 90 per cent. of their face value and proceeds used for erecting buildings and purchase of machinery and equipment.

The preferred stock is sold at 85 and one share of common stock is given with each share of preferred stock, the common stock remaining being disposed of at 40. How would you deal with the discount in each case?

(5) A company whose capital stock is $250,000, divided into $100,000 6 per cent. non-cumulative preferred shares, and $150,000 common shares, begins its life with an excess of liabilities over real assets to the extent of $10,500, which sum is debited to suspense account. During the first few years small

losses are made and carried forward on the profit and loss account but finally sufficient profits are earned to wipe out the losses of the previous years and leave a balance of $16,500.

The holders of the preferred stock claim that any surplus profit, after payment of the preference dividend, should be used to extinguish the suspense account.

The holders of the common stock claim that all of such surplus is properly available for their dividend on the ground that the original deficiency carried to suspense account was in effect a charge to goodwill.

Give briefly your understanding of "goodwill." State how you would deal with it in this case, and whether the directors may pay any dividend on the common stock.

(6) A suburban traction company, after equipping its line at a very considerable expense for overhead trolley, and operating same for several years, decides to adopt the third-rail system. Extensive changes are necessary in changing power houses, re-arranging tracks, and altering cars, involving an expenditure of $25,000. In addition considerable machinery and rolling stock, the original cost of which had been treated as a capital outlay and was carried on the books at a valuation of $25,000, is rendered obsolete, and is disposed of for $3,500, showing a loss of $21,500. The profits from operation for the year $18,000.

State how you would recommend that the matter be dealt with in the company's accounts, and whether the company can pay a dividend?

(7) A firm having several branches maintains an account with each branch in the ledger and charges to such account all goods sent to the agents for stock. When stock is taken the balance of each branch account is treated as ordinary accounts receivable and is included in the general debts owing to the firm. If you see any objections to this method, state them, and say how you would deal with the accounts.

(8) Presuming that upon examination of a merchant's accounts the balance shown by the bank pass-book, or certified by the bankers, agreed with the balance shown in the merchant's cheque-book, would you consider any further examination necessary?

State reasons for your reply.

(9) Define your understanding of principle involved in determining what are and what are not expenditures from capital.

(10) You are instructed to make an audit by a merchant selling finished goods, or by a manufacturer. State all your responsibilities. Name the financial statements you should make and give a form of certificate.

CALIFORNIA.

Examination held May 28, 1908.
(Part of questions only.)

(1) State the different kinds of audits and describe them.

(2) What would be required from a firm or corporation by an auditor before entering upon the audit of the books?

(3) In making the first periodical audit of a corporation that had personally taken over the business of a firm, what would you include in your examination beside the usual books and accounts, and for the purpose of ascertaining what facts?

(4) From the information gathered and noted throughout an audit, what matters would you call especial attention to, and what schedules and statistical statements would you furnish the client?

(5) What constitutes capital expenditure?

(6) Would an auditor be justified in certifying to the accuracy of accounts in which such expenditure appeared without making inquiry into the real character of same. If not, why not? If he would, why?

WASHINGTON.

Examination held August 7, 1908.

(1) What are the responsibilities of an auditor and what should be his qualifications?

(2) (a) Give some reasons why a firm or corporation should have periodical audits.

(b) What advantage has a firm or corporation in employing a Certified Public Accountant for the work?

(c) How far should an auditor enquire into the work of his predecessor.

(3) Draw up a form of certificate you would give where you found the accounts properly kept. Also where accounts are incorrect.

(4) (a) Explain how you would proceed in auditing the affairs of a corporation.

(b) In an audit where an exhaustive examination of the books is not practicable, what are the particular points to which the attention of an auditor should be directed?

(5) State briefly your duties as an auditor in reference to the following matters:

(a) Machinery the value of which has not been regularly depreciated.

(b) Loans from bankers.

(c) Doubtful debts.

(d) Goodwill.

(6) How would you as auditor of an incorporated company satisfy yourself of the existence of shares or bonds given as security for loans to the company?

(7) What important items would you look for in auditing accounts of a county, a city and a school district?

(8) A firm of export merchants desires a thorough investigation of the past year's transactions, having reason to suspect fraud. State concisely upon what lines you would proceed to satisfy yourself that:

(a) Goods had been taken out of the store on bond in the way shown by the books.

(b) They had been shipped to account of proper consignee.

(c) That no goods had been removed without being charged.

(d) That no fictitious entries had been made in the books.

MICHIGAN.

Examination held June 26, 1908.

(1) What is an auditor's duty with regard to the following items appearing upon a balance sheet? Imprest cash, notes receivable, customers' accounts, sundry debtors, mortgages payable, certificates of deposit, patents, goodwill, preliminary (or organization) expenses, stocks and bonds, purchase creditors' accounts and sundry creditors.

(2) What do you understand by the term "secret or hidden reserves?" Mention four (4) bona fide uses of a secret reserve and state your opinion as to the propriety or otherwise of the creation of such "reserves," giving reasons.

(3) The J. B. & B. Coal Mining Company has acquired a leasehold right to a certain area of coal, and also owns freehold coal. What would you require as auditor, to satisfy yourself that revenue was bearing its proper annual charge in respect of the coal mined?

(4) Chart the following accounts of a street railway company under their proper classification and logical order, as to

assets (active, fixed, and passive), liabilities (funded, floating, reserves and capital), expenses (transportation, including operating of power plant and car service), general (including administrative, emergencies and fixed charges), maintenance, (including repairs and depreciation) and revenue (a) from operation and (b) from other sources.

Organization expenses, preliminary engineering and superintendence, right of way, track and roadway, notes payable, cash in office, profit and loss, power plant wages, salaries of general officers, damages, taxes, electric line, investment real estate, debentures, vouchers payable, stocks and bonds of other companies, hired power, wages of conductors and motormen, car service supplies, insurance, first mortgage bonds, Ninth National Bank, cleaning and sanding tracks, printing and stationery, legal expenses, rent of land and buildings, notes receivable, shop tools and machinery, passenger receipts, rolling equipment, dividends, material and supplies, freight receipts, interest on deposits, track rentals, common stock, sinking funds, goodwill, mail receipts, sale of power, dividends on securities, salaries of clerks, removal of snow and ice, advertising and attractions, storeroom expenses, steam plant, items in suspense, impairment and surplus, first preferred stock, repairs to equipment, reserves, accounts receivable, second preferred stock, second mortgage bonds, fuel and water for power buildings, and fixtures.

(5) A $100.00 bond is issued at $115.00 and is payable as to $35.00 on allotment and to the remaining $80.00 in four equal instalments at intervals of two months, the first instalment being due two months after the allotment. If after a year a dividend of $6.00 is paid on each bond, what is the average rate of interest on the investment for the whole year?

(6) John Adams, a capitalist, contemplates purchasing the stock of the American Grain Exporting Company, a corporation organized with a capital of $200,000.00, divided into 1,000 shares preferred stock and 1,000 shares common stock, par

value $100.00 each, six per cent. (6%) dividends, payable upon the preferred stock before any dividends are declared upon the common stock.

This stock has been offered to Mr. Adams at $60.00 per share for the preferred, and $40.00 per share for the common.

You are requested to audit the books of the company and give your opinion as to the value of the stock. You find the following accounts to be correct, covering a period of one year.

Cash		$900.00	
Accounts receivable:			
Good	$15,000.00		
Doubtful	4,000.00		
Bad	6,000.00	25,000.00	
Plant and machinery		75,000.00	
Horse and wagons		4,000.00	
Merchandise—Inventory		29,000.00	
Goodwill		50,000.00	
Furniture and fixtures		2,000.00	
Expenses		3,000.00	
Wages		15,000.00	
Purchases		325,000.00	
Claims and rebates		8,000.00	
Ordinary repairs		9,000.00	
Sales			$260,400.00
Mortgage on plant			25,000.00
Accounts payable			42,000.00
Surplus			18,500.00
Capital stock			200,000.00
Totals		$545,900.00	$545,900.00

Inventory submitted $129,000.00. The company started business six years ago and built the plant and machinery and purchased the property pertaining to fixed capital. Write the report, commenting upon the advisability of the purchase and submit profit and loss statement and balance sheet, after closing books.

(7) The cashier of a firm has disappeared. The cash book is left written up and balanced off, the custom being to pay any cash balance into the bank each day. What course would

you take to ascertain whether there were any defalcations, if you were called upon to audit?

(8) You are asked by a client how to treat inventories at the time of closing the books, e. g., should they be figured at cost or market price, or otherwise? Is the common, old-fashioned method of adding the inventory of merchandise on hand, to the credit side of the merchandise account before closing the books, theoretically correct? Explain fully.

(9) What evidence would you require as to the validity of expenditure in respect of wages paid in a large manufacturing plant, and as to the value of the inventories of stock on hand credited to loss and gain? It is assumed that the above manufacturing concern kept a complete cost system, which was an integral part of the general books.

(10) The market value of the investments of a trust company has fallen considerably, while the company has earned enough income to pay the usual dividend. How should you deal with this position of affairs in auditing the annual accounts?

FLORIDA

Examination held April 22, 1908.

(1) A trading company discounts some of its bills receivable. How would you treat such transactions in the books, and how would you show such discounted bills on the balance sheet?

(2) What do you consider the proper way to handle cash in accounts? What advantages are there, if any, in banking each day the exact receipts of the previous day?

How would you verify the correctness of a cash book, and ensure the entry of all cash received?

(3) Define "periodical audit" and "continuous audit." Give two or three reasons for and against each.

(4) What is an "internal check?" How does such a check affect the work of auditing a given set of accounts?

Give at least one example.

(5) What are the objects of and differences between an audit and an examination?

(6) Give in detail the method you would follow in auditing some company with which you are familiar.

(7) What especial duties has auditor in connection with accounts relating to:—

Patents owned by a corporation.

Timber rights owned by a corporation.

Machinery and boilers owned by a corporation.

(8) Give at least two examples of contingent liabilties, and state how they should be treated in the books and on the balance sheet.

(9) A company is organized in New York to lend money on real estate mortgages in Florida.

What examination should an auditor make of such mortgages, and how would he guard against duplicate mortgages on the same property?

(10) A new company sells some of its property at a premium.

State how these premiums should appear in the accounts.

(11) Suppose you had certified the balance sheet of a manufacturing concern, and were asked by a stockholder why you had certified it as correct when some of the assets were not salable at the figures placed against them, what reply would you make?

(12) What duties and responsibilities has an auditor in connection with inventories of goods on hand?

(13) A firm has been doing business for ten years, during which time no audit has been made and nothing has been charged off on account of bad debts. There are six hundred accounts on the ledger.

State how you would verify and classify them.

(14) In auditing the accounts of an executor, what documents would you require?

What is the necessity of keeping real estate separate from personal property?

(15) Give your opinion as to the advantages, or disadvantages, of bound and of loose-leaf ledgers; and give at least two methods for preventing improper abstracting of leaves from loose-leaf books.

RHODE ISLAND.

Examination held December 26, 1907.

(1) What is your understanding of a cash audit?

(2) What measures do you adopt to protect yourself against imposition by persons who have access to the books while you are auditing them?

(3) What proofs do you apply to insure the correctness of an audit?

(4) A company owns all the capital stock of another company. This company has outstanding an issue of bonds not guaranteed by the company holding the stock. The assets of this subsidiary company are deemed insufficient to cover the bonds, so that its capital stock has no value. The owning company desires the auditor to prepare its balance sheet, setting up the assets of this subsidiary company along with other assets directly owned and the bonds as liabilities. Is it proper for him to do so under the circumstances? Give reasons for your answer.

(5) What do you consider a complete checking of (a) the general journal (b) the purchase journal?

(6) What is your method of checking dividends paid?

(7) A New York company sells its capital stock at a premium and the directors pass a resolution to declare a dividend out of the surplus thus paid in. Would you call attention to this action if asked to make up the accounts, and if so, why?

(8) In examining the books of a corporation you find that an officer is a partner in a business from which the corporation makes purchases. Upon scrutiny you find that all the transactions are at proper figures. Would you, under such conditions, call attention to the fact when making your report to the directors?

(9) A concern owns a parcel of real estate which cost it $500,000. There is a purchase money mortgage on it of $350,000. You are asked to enter the same in the balance sheet of $350,000 net. Would you comply with this request? Give reasons for your answer.

(10) A person is interested in the profits of a corporation, but is not a shareholder therein. He objects to having the preliminary expenses enter into the profit and loss accounts. Is his position tenable? Give reasons.

(11) A manufacturing concern buys raw materials in advance for its needs. These are liable to fluctuations. At what prices should they be inventoried? Why?

(12) Under the law permitting payment of dividends solely out of surplus earned, a corporation pays a dividend out of general surplus after carrying its losses for the period against the account. Would you make mention of the fact in the recital accompanying your statements, or would you let it go without specific mention? Give reasons.

(13) Three months after the close of the fiscal year you are requested to audit a set of books to the end of the fiscal year. How do you ascertain if the cash called for by the books was actually on hand and in bank?

(14) A teller is found to be short in his cash. He has been in the position for a period of three years and has a daily record of cash on hand. His bond of suretyship antedates the discovery of the shortage by a period of six months, and it contains a clause that the surety shall not be liable for a shortage existing at the date the bond became effective. You are employed by the surety to ascertain if the shortage falls within the period of the bond. What steps would you take? Do you think that you would be successful?

(15) What is the objection to loose-leaf depositors' ledgers?

APPENDIX F.

The following extract from the translation of Sir Walter of Henley's "Tretyce off Housebandry" (a manuscript work of the thirteenth century) is of considerable interest, as showing the remarkable similarity of the duties of the Auditor of the present day with those of the Auditor of seven hundred years ago:—

"Buy and sell in season through the inspection of a true man or two who can witness the business, for often it happens that those who render accounts increase the purchases and diminish the sales. Have an inspection of account, or cause it to be made by some one in whom you can trust, once a year, and final account at the end of the year. View of Account is made to know the state of things, as well as the issues, receipts, sales, purchases, and expenses, and for raising money. If there is any (money), let it be raised and taken from the hands of the servants. For it often happens that servants by themselves, or others, make merchandise with their lord's money to their own profit; and if arrears appear in the final account, let them be speedily raised, for often servants are debtors themselves, and make others debtors whom they ought not—and this they do to conceal their disloyalty. Those who have the goods of others in their keeping ought to keep well four things: to love their lord and respect him; as to making profit, they ought to look on the business as their own; as to outlays, they ought to think that the business is another's. But there are few servants who keep these four things altogether, as many take, right and left, where they judge that their disloyalty will not be perceived. Look into your affairs

often, and cause them to be reviewed, for those who serve you will thereby avoid the more to do wrong, and will take pains to do better.

"In the first place, he who renders account ought to swear that he will render a lawful account, and faithfully account for what he has received of the goods of his lord, and that he will put nothing in his roll save what he has to his knowledge spent lawfully, and to his lord's profit. And the clerk shall swear that he has lawfully entered in his roll what he understands his master has received of the lord's goods, and has entered nothing in the roll but what he understands may be to the profit of the lord. And then, if he has rendered account before, see how it compares; and if he is found in arrears of money, corn, or stock, put the whole in a stated money valuation, and charge it at the commencement of his roll, also charge it with receipts of rents and many other things.

"At the end of the year, when all the accounts shall have been rendered of the lands, the issues, and all expenses of the manor, take to yourself all the rolls, and by one or two of the most intimate and faithful men you have, make very careful comparison with the rolls of the accounts rendered, and of the rolls of the estimate of corn and stock, and according as they agree you shall see the industry or negligence of your servants and bailiffs.

"The lord of the manor ought to command and ordain that the accounts be heard every year, not in one place, but on all the manors, for so can one quickly know everything, and understand the profit and loss. The lord ought to command the Auditors on the manors to hear the plaints and wrongs of everybody who complains of the steward or others, that full justice be done, and that the Auditors do right at their peril.

"The Auditors ought to be faithful and prudent, knowing their business, and all the points and articles of the account in rents, outlays, and returns of stock. And the accounts

ought to be heard at each manor, to know the profit and loss, and then can the Auditors take inquest of the doings which are doubtful, and hear the plaints of each plaintiff and make the fines. The steward ought to be joined with the Auditors, not as head or companion of the account, but as sub-ordinate, for he must answer to the Auditors on the account for his doings, just as another. It is not necessary so to speak to the Auditors about making audits, for they ought to be so prudent, and so faithful, and so knowing in their business, that they have no need of others' teaching about things connected with the accounts."

APPENDIX G.

CORPORATION TAX LAW.

Text of the law, criticism thereof from an accounting standpoint, and suggestions for making the returns required from corporations.

With the exception of the period from 1817 to 1842, Great Britain has taxed incomes for over a century, the need of funds caused by the Napoleonic wars being the occasion of the first income tax law, which was enacted in 1798. The law in force at the present time was passed in 1853, having been modified in some particulars by amendments at different times since.

In the United States an income tax was proposed in 1812 as a means of raising revenue for the prosecution of the war with Great Britain, but it found no favor with Congress, and the act was never passed. In 1861, however, at the time of the Civil War, a law taxing incomes was enacted, such taxation continuing until 1872, when it was discontinued.

In 1894 there was passed by Congress, as a part of the Wilson tariff bill, a law levying a tax of two per cent. on incomes in excess of $4,000. This act was declared unconstitutional by the Supreme Court as being in conflict with clause 4 of Article I, Section IX of the Federal constitution, which reads:

"No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken."

The income tax levied in the years 1862 to 1872 was open to the same constitutional objection, but this seems to be one of the cases in which the Supreme Court reversed itself, the older law having been upheld by that Court.

The act passed by Congress in 1909 as a part of the Payne tariff bill, taxing the net income of corporations, is—any legal fiction to the contrary notwithstanding—an income tax, though in this instance limited to the "net income" of corporations as distinguished from all incomes, whether of corporations, partnerships or individuals. This is quite clearly seen when a comparison is made of the act recently passed with that section of the act of 28th August, 1894, pertaining to the tax on the net profits or income of corporations. On this point it is interesting to note the opinion of one of the leading experts on taxation in this country—Lawson Purdy, President of the Department of Taxes and Assessment of New York City, who is quoted as saying: "From whatever point of view the Federal Corporation Tax is studied, it is unworkable and unjust; it encroaches upon the powers of the States; it is not productive of revenue; it is needlessly inquisitorial; the publicity required is rash and dangerous in the extreme. Its name is a subterfuge. It is an income tax, and not an excise tax. It has the vices of income taxes, without the merits of an income tax scientifically framed."

The text of the present law, being Section 38 of the Payne tariff bill, approved 5th August, 1909, is as follows:

Corporations Subject to Tax.

Sec. 38. That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company now or hereafter organized under the laws of the United States or of any State or Territory of the United States, or under the Acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia,

*The marginal notes are not an integral part of the law, but have been added for the convenience of the reader.

shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; or if organized under the laws of any foreign country, upon the amount of net income over and above five thousand dollars received by it from business transacted and capital invested within the United States and its Territories, Alaska, and the District of Columbia during such year, exclusive of amounts so received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed: *Provided, however,* That nothing in this section contained shall apply to labor, agricultural or horticultural organization, or to fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations, and dependents of such members, nor to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members, nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.

1 Per Cent. of "Net Income" Over $5,000.

Foreign Corporations.

Corporations Not Subject to Tax.

Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint stock company or association, or insurance company, received within the year from all sources:

1st. All the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges, such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property.

2nd. All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds.

How "Net Income" Shall Be Ascertained.

3rd. Interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, all interest actually paid by it within the year on deposits.

4th. All sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein.

5th. All amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed:

How "Net Income" of Foreign Corporations Shall Be Ascertained.

Provided, That in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, such net income shall be ascertained by deducting from the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia:

1st. All the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States and its Territories, Alaska, and the District of Columbia, including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property.

2nd. All losses actually sustained within the year in business conducted by it within the United States or its Territories, Alaska, or the District of Columbia not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds.

3rd. Interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia bears to the gross amount of its income derived from all sources within and without the United States.

4th. The sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof.

5th. All amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, and insurance companies, subject to the tax hereby imposed. In the case of assessment insurance companies, the actual deposit of sums with State or Territorial officers, pursuant to law, as additions to guaranty or reserve funds shall be treated as being payments required by law to reserve funds.

Tax to Be Computed on "Net Income" in Excess of $5,000.

Third. There shall be deducted from the amount of the net income of each of such corporations, joint stock companies or associations, or insurance companies, ascertained as provided in the foregoing paragraphs of this section, the sum of five thousand dollars, and said tax shall be computed upon the remainder of said net income of such corporation, joint stock company or association, or insurance company, for the year ending December thirty-first, nineteen hundred and nine, and for each calendar year thereafter; and on or before the first day of March, nineteen hundred and ten, and the first day of March in each year thereafter, a true and accurate return, under oath or affirmation of its president, vice-president, or other principal officer, and its treasurer or assistant treasurer, shall be made by each of the corporations, joint stock companies or associations, and insurance companies, subject to the tax imposed by this section, to the collector of internal revenue for the district in which such corporation, joint stock company or association, or insurance company, has its principal place of business, or, in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, in the place where its principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth:

Annual Reports Required.

What Shall Be Included in Returns.

1st. The total amount of the paid-up capital stock of such corporation, joint stock company, or association, or insurance company, outstanding at the close of the year.

2nd. The total amount of the bonded and other indebtedness of such corporation, joint stock company or association, or insurance company at the close of the year.

3rd. The gross amount of the income of such corporation, joint stock company or association, or insurance company, received during such year from all sources, and if organized under the laws of a

foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia; also the amount received by such corporation, joint stock company or association, or insurance company, within the year by way of dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed by this section.

4th. The total amount of all the ordinary and necessary expenses actually paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint stock company or association, or insurance company, within the year, stating separately all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property, and if organized under the laws of a foreign country the amount so paid in the maintenance and operation of its business within the United States and its Territories, Alaska, and the District of Columbia.

5th. The total amount of all losses actually sustained during the year and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; and in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year in business conducted by it within the United States or its Territories, Alaska, and the District of Columbia, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve fund.

6th. The amount of interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, stating separately all interest paid by it within the year on deposits; or in case of a corporation, joint stock company or association, or

insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States.

7th. The amount paid by it within the year for taxes imposed under the authority of the United States or any State or Territory thereof, and separately the amount so paid by it for taxes imposed by the government of any foreign country as a condition to carrying on business therein.

8th. The net income of such corporation, joint stock company or association, or insurance company, after making the deductions in this section authorized. All such returns shall, as received, be transmitted forthwith by the collector to the Commissioner of Internal Revenue.

Incorrect Reports.

Fourth. Whenever evidence shall be produced before the Commissioner of Internal Revenue which, in the opinion of the Commissioner, justifies the belief that the return made by any corporation, joint stock company or association, or insurance company, is incorrect, or whenever any collector shall report to the Commissioner of Internal Revenue that any corporation, joint stock company or association, or insurance company, has failed to make a return as required by law, the Commissioner of Internal Revenue may require from the corporation, joint stock company or association, or insurance company making such return, such further information with reference to its capital, income, losses and expenditures as he may deem expedient; and the Commissioner of Internal Revenue, for the purpose of ascertaining the correctness of such return or for the purpose of making a return where none has been made, is hereby authorized, by any regularly appointed revenue agent specially designated by him for that purpose, to examine any books and papers bearing upon the matters required to be included in the return of such corporation, joint stock company or association, or insurance company, and to require the attendance of any officer or employee of such corporation, joint stock company or association, or insurance company, and to take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons; and the Commissioner of Internal Revenue may also invoke the

Failure to Report.

Books May Be Examined.

Aid of Courts May Be Invoked.

aid of any court of the United States having jurisdiction to require the attendance of such officers or employees and the production of such books and papers. Upon the information so acquired the Commissioner of Internal Revenue may amend any return or make a return where none has been made. All proceedings taken by the Commissioner of Internal Revenue under the provisions of this section shall be subject to the approval of the Secretary of the Treasury.

Additions to Tax for False or No Return.

Fifth. All returns shall be retained by the Commissioner of Internal Revenue, who shall make assessments thereon; and in case of any return made with false or fraudulent intent, he shall add one hundred per centum of such tax, and in case of a refusal or neglect to make a return or to verify the same as aforesaid he shall add fifty per centum of such tax. In case of neglect occasioned by the sickness or absence of an officer of such corporation, joint stock company or association, or insurance company, required to make said return, or for other sufficient reason, the collector may allow such further time for making and delivering such return as he may deem necessary, not exceeding thirty days. The amount so added to the tax shall be collected at the same time and in the same manner as the tax originally assessed unless the refusal, neglect, or falsity is discovered after the date for payment of said taxes, in which case the amount so added shall be paid by the delinquent corporation, joint stock company or association, or insurance company, immediately upon notice given by the collector. All assessments shall be made, and the several corporations, joint stock companies or associations, or insurance companies, shall be notified of the amount for which they are respectively liable on or before the first day of June of each successive year, and said assessments shall be paid on or before the thirtieth day of June, except in cases of refusal or neglect to make such return, and in cases of false or fraudulent returns, in which cases the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, make a return upon information obtained as above provided for, and the assessment made by the Commissioner of Internal Revenue thereon shall be paid by such corporation, joint stock company or association, or insurance company immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the thirtieth day of June in any year, and for ten days after notice and demand thereof by the collector, there shall be added the sum of five per centum on the amount of tax unpaid and interest at the rate

Delinquent Taxes.

of one per centum per month upon said tax from the time the same becomes due.

Reports Public Records.

Sixth. When the assessment shall be made, as provided in this section, the returns, together with any corrections thereof which may have been made by the Commissioner, shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such.

Information Not to Be Divulged.

Seventh. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or make known in any manner whatever not provided by law to any person any information obtained by him in the discharge of his official duty, or to divulge or make known in any manner not provided by law any document received, evidence taken, or report made under this section except upon the special direction of the President; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding one thousand dollars, or by imprisonment not exceeding one year, or both, at the discretion of the court.

Penalty for False or No Return.

Eighth. If any of the corporations, joint stock companies or associations, or insurance companies, aforesaid, shall refuse or neglect to make a return at the time or times hereinbefore specified in each year, or shall render a false or fraudulent return, such corporation, joint stock company or association, or insurance company, shall be liable to a penalty of not less than one thousand dollars and not exceeding ten thousand dollars.

Any person authorized by law to make, render, sign, or verify any return, who makes any false or fraudulent return, or statement, with intent to defeat or evade the assessment required by this section to be made, shall be guilty of a misdemeanor, and shall be fined not exceeding one thousand dollars or be imprisoned not exceeding one year, or both, at the discretion of the court, with the costs of prosecution.

Internal Revenue Laws Apply.

All laws relating to the collection, remission, and refund of internal revenue taxes, so far as applicable to and not inconsistent with the provisions of this section, are hereby extended and made applicable to the tax imposed by this section.

United States Circuit and District Courts Have Jurisdiction.

Jurisdiction is hereby conferred upon the circuit and district courts of the United States for the district within which any person summoned under this section to appear to testify or to produce books, as aforesaid, shall reside, to compel such attendance, production of books, and testimony by appropriate process.

As is under our American legislative methods so frequently the case, those best qualified to advise on special phases of contemplated legislation are not consulted, and laws are passed which impose an unnecessary burden on those subject thereto. An apt illustration of this is the corporation tax act just quoted.

To an accountant perusing the provisions of this act, it is at once evident that no member of the profession could have been consulted when the law was framed. Inasmuch as the determination of the tax to be paid under a law of this kind is primarily an accounting question, the omission to call into consultation those most competent to advise as to the simplest basis on which to determine the amount of tax to be paid by the corporations is incomprehensible. It is obvious that no consideration at all was paid to the convenience of those who must pay this tax, viz., the corporations. Even if the law is declared to be unconstitutional, no decision can be expected until after the time for the first returns has passed.

As soon as the text of the proposed law was published, however, public accountants were quick to perceive the gross errors from an accounting standpoint contained therein, and a copy of the following letter, signed by twelve prominent firms of New York City, was sent to each member of Congress and to the Attorney General of the United States:

NEW YORK CITY, July 8th, 1909.

DEAR SIR:

On reading the text of the proposed corporation tax law, as reported in the *Commercial and Financial Chronicle* of July 3rd, 1909, we have formed the opinion that some of its provisions are absolutely impossible of application, and others violate all the accepted principles of sound accounting.

Under the third clause it is provided "that there shall be deducted from the amount of the net income of each of such corporations, . . . ascertained as provided in the foregoing paragraphs of this section, the sum of $5,000.00, and said tax shall be computed upon the remainder of said net income of such corporation . . . for the

year ending December 31st, 1909, and for each year thereafter, and on or before the 1st day of March, 1910, and the 1st day of March of each year thereafter, a true and accurate return under oath or affirmation of its president," etc., etc.

In connection with this clause we would call attention to the fact that, as you are no doubt aware, the fiscal year of a number of corporations is not, and for business reasons cannot be, the calendar year, and consequently, having in mind that in such cases an inventory was not taken at the beginning of the calendar year 1909, it is and will be quite impossible for any business, corporation or institution, whose fiscal year does not terminate with the calendar year, to make a true return of its profits as required by the proposed law.

Under clause 1 the tax is to be charged upon the "entire net income," and the net income is to be "ascertained by deducting from the gross amount of the income . . . from all sources,"

(1) "Expenses actually paid,"

(2) "Losses actually sustained,"

(3) "Interest actually paid,"

in each case "within the year." The words "actually paid" convey, and it is to be presumed are intended to convey, actual disbursements out of the treasury.

The proper deductions should be:

(1) Expenses actually incurred because the payment is not necessarily made in the year in which the expense is incurred;

(2) Losses actually ascertained because losses may be incurred and the amount not be ascertained until a subsequent period;

(3) Interest actually accrued because interest is never paid until the end of the period during which it accrues, and the interest accrued is the proper charge against income.

In clause 1 the bill refers to "net income received"; in clause 2 it refers to "gross income" without the addition of word "received"; in clause 3, paragraph 3, it refers to "gross income received." There is here a complete confusion between income and income received, which can only lead to endless complication.

Two methods may be adopted for taxation purposes, either

(1) To tax the difference between actual cash receipts on revenue account and actual cash payments on revenue account, which difference will seldom if ever represent the profits of a manufacturing concern; or

(2) To tax profits made up in the ordinary commercial way, namely, to ascertain the gross income earned, whether received or not, and to deduct therefrom—

1. Expenses actually incurred during the year, whether paid or not;

2. Losses actually ascertained and written off during the year whenever incurred;

3. Interest accrued during the year, whether paid or not;

4. A reasonable allowance for depreciation of property; and

5. Taxes.

As accountants actively engaged in the audit and examination of a number of varied businesses and enterprises, we unhesitatingly say that the law as framed is absolutely impossible of application, and would suggest that in the said clauses 1, 2 and 3 of paragraph 2, the words "actually paid" and "actually sustained" be changed to read "actually incurred" and "actually ascertained," and that the third clause be changed to read so that the return will be based on the last completed fiscal year prior to December 31st in cases where the fiscal year of a corporation is not the calendar year.

Yours very truly,

DELOITTE, PLENDER, GRIFFITHS & Co., 49 Wall Street.
PRICE, WATERHOUSE & Co., 54 William Street
HASKINS & SELLS, 30 Broad Street.
LYBRAND, ROSS BROS. & MONTGOMERY, 165 Broadway.
WILKINSON, RECKITT WILLIAMS & Co., 52 Broadway.
NILES & NILES, 111 Broadway.
GUNN, RICHARDS & Co., 43 Wall Street.
EDWARD P. MOXEY & Co., 165 Broadway.
GEO. H. CHURCH, 55 Wall Street.
BARROW, WADE, GUTHRIE & Co., 25 Broad Street.
LOOMIS, CONANT & Co., 30 Broad Street.
MARWICK, MITCHELL & Co., 79 Wall Street.

To this letter the Attorney General replied as follows:

WASHINGTON, D. C., July 12th, 1909.

MESSRS. DELOITTE, PLENDER, GRIFFITHS & Co.,
49 Wall Street, New York.

GENTLEMEN:

I am in receipt of the letter signed by your firm and a number of others with respect to the proposed corporation tax law, in which you advise me that you have formed the opinion that some of its provisions are absolutely impossible of application and others violate all the accepted principles of sound accounting.

You first call my attention to the fact that "the fiscal year of a number of corporations is not, and for business reasons cannot be, the calendar year, and consequently, having in mind that in such cases an inventory was not taken at the beginning of the calendar year 1909, it is and will be quite impossible for any business, corporation or institution, whose fiscal year does not terminate with the calendar year, to make a true return of its profits as required by the proposed law."

I beg to call your attention, in the first place, to the fact that the proposed law does not impose a tax upon "profits" but upon "the entire net income over and above five thousand dollars received by" the corporation, joint stock company or association, or insurance company subject to the law, from "all sources during such year." It has been the uniform practice of the Government in framing revenue bills to require the tax to be paid as of a fixed date, and, so far as I have been able to ascertain, in every instance the tax is imposed for the calendar year ending December 31st. Such was the income tax law of 1894. It may be inconvenient, but it is certainly not impossible for any corporation which keeps just and true books of account to make up a return such as that required by the proposed law, particularly as the return requires statements of actual receipts and payments, and not, as you recommend in your communication, of expenses "incurred," interest "accrued," and losses "ascertained."

2. You next object that the proposed law authorizes the deductions of "expenses actually paid," and you contend that this should be changed to read "expenses actually incurred." The bill was purposely framed to deal with receipts and disbursements made within the year for which the tax was to be imposed, and the words "actually paid" were employed advisedly. The same may be said with respect to losses actually sustained and interest actually paid. The theory of the framers of the bill in this respect differs from that which you advocate.

3. You then object that in Clause 1 the bill refers to "net income received"; in Clause 2 it refers to "gross income" without the addition of the word "received"; and in Clause 3, Paragraph 3, it refers to "gross income received," and you comment: "There is here a complete confusion between income and income received, which can only lead to endless complication."

I cannot agree that there is any confusion whatever in this respect. "Gross income" in Clause 2 obviously and necessarily means "gross income received." The tax is imposed by Clause 1 upon the entire net income above five thousand dollars received from all sources during the year. By Clause 2 "such net income" is to be ascertained by deducting from the gross amount of the income from all sources the specified items; and if anybody could question whether that meant

"gross income received," his doubt would be removed by the provisions in Paragraph 3 of Clause 3.

Your further statement that "as accountants actively engaged in the audit and examination of a number of varied businesses and enterprises, we unhesitatingly say that the law as framed is absolutely impossible of application," causes me very great surprise. My personal acquaintance with you and a number of the other signers of the letter leads me to the belief that you have underestimated your capacity. Certainly the statement of objections made in your letter is entirely insufficient to support the conclusion which you express.

I am, respectfully yours,

(Signed) GEO. W. WICKERSHAM,
Attorney-General.

On receipt of this letter the following reply was written, giving in somewhat more detail the reasons for stating that the law as framed was practically impossible of application:

NEW YORK, July 21st, 1909.

HON. GEO. W. WICKERSHAM,
Attorney-General of the United States,
Washington, D. C.

DEAR SIR:

We have to acknowledge receipt of your letter of July 12th, replying to ours of July 8th.

Our only object in addressing you was to be of assistance in a matter of practical accounting which enters into the proposed law, as to which we believe that our experience specially qualifies us to speak. We have purposely refrained from any reference to the policy involved in the law, with which we as Accountants are not concerned.

The views expressed in your letter of the 12th instant would seem to indicate that you have not fully appreciated the difficulties which will be met with in carrying into effect the provisions of the proposed law as amplified and explained in your letter; and we therefore feel that, in justice to ourselves, we must refer at greater length to some matters which were only briefly touched upon in our letter of July 8th.

We are glad to have your clear expression as to the intention of the law to deal with Receipts and Disbursements only (presumably on Income Account) and not with Income Earned (or Profits) and Expenditures incurred. Under these circumstances it would seem better to use the term "Receipts on Income Account" and "Disbursements on Income Account" rather than "Income" and "Expense," as the latter terms are more commonly defined and used in relation to Income

earned and Expenses incurred. In any case, if in Clause 2 "Gross Income" means, as you state it is intended to mean, "Gross Income received," it would certainly be better to say so and thus remove any possible ambiguity.

We note that you refer to the precedent of the Income Tax Law of 1894. We believe that this law was declared unconstitutional before there had been time to experience the difficulties and uncertainties which any attempt to enforce it, if drawn on the lines of the present bill, would have involved. In this connection we may perhaps point to the precedent of the English Income Tax Law which has stood the test of over half a century. In this case the tax is on Profits, which in this country are frequently termed "Net Income"; and the accounts of corporations prepared in the regular course of business for their respective fiscal years are and always have been accepted as the basis of taxation, subject to minor provisions as to rates of depreciation, interest deductions, etc.

Our main criticism of the bill in its present form is that in the large majority of cases it will be impossible of application for the year 1909, as explained in our previous letter, and very difficult and expensive, if not altogether impossible, in subsequent years.

Railroads perhaps require the simplest form of accounting obtaining among business corporations. These accounts are kept in a form prescribed by the Interstate Commerce Commission, and severe penalties can be inflicted for any departure from those forms. They must be kept on a basis not of Receipts and Disbursements, but of Earnings, whether collected in cash or not, and of Expenses, whether paid or not, which in both cases accrued during the fiscal year closing on June 30th, the outstanding Income and Expense items uncollected and unpaid running into very large figures and frequently varying considerably in amount between one year and another. While it would be possible to prepare also an account of Receipts and Disbursements, this would involve a great deal of extra work in the compilation of special data and would raise most difficult questions as to the proper distribution between Capital and Income of large payments for stores, the ultimate use of which is not and cannot be known at the time of payment.

Turning now from this, which is perhaps the most simple case, to that of a large manufacturing concern producing all kinds of finished products out of purchases of ore and other raw materials, an accurate or even approximate statement of cash Receipts and Disbursements on Income Account is a practical impossibility at any time. Cash Receipts arising from sales of products can be ascertained without much difficulty beyond requiring considerable extra work. But no system

of accounting can give even approximately "the ordinary and necessary expenses actually paid within the year out of Income in the maintenance and operation of its business and properties." Such expenses presumably must include the cost of the goods sold. Into this cost, and following it through all the intricate accounting which has been found to be necessary, are raw materials actually used in manufacture, labor expended and innumerable items of expense which are taken into costs as they accrue, quite irrespective of the date of payment. Very large inventories are carried of materials and supplies which are purchased at one period, paid for at another, and used at all sorts of times in all sorts of quantities, and for all sorts of purposes, mainly for manufacture into products for sale, but to a large extent for additions to or extensions of the plant. Such as are user for the latter purpose are not, as we understand the proposed law, a proper deduction from Gross Income, and yet long before they are used all identity between the materials themselves and the disbursements made for them has been lost. There is, in our opinion, no method in which any such statement as that called for in the proposed law can be prepared short of an entirely independent and separate set of books, designed to follow each bill paid through to the ultimate destination of the materials or services covered thereby, thus duplicating the present cost of the Accounting Department and serving no useful purpose whatever. Even if such method were adopted it is very doubtful if it would produce the results required with even approximate accuracy.

Without unduly burdening this letter, it is impossible to go into further details here; but the facts must, in the opinion of any one familiar with the operations and accounts of a complicated modern manufacturing concern, fully justify the conclusions which we expressed in our letter of July 8th, and which we now emphatically endorse. Whether the proposed method is physically impossible, or merely, as you state, "inconvenient," it will, we think, be generally conceded that it is in the general interest of the effective administration of laws relating to taxes that they should involve as little inconvenience as possible upon those required to make returns thereunder. The basis for arriving at the amount liable to taxation suggested in our former letter would have the advantage of simplicity, and if the tax is to be a permanent institution, its efficient operation would be greatly facilitated by conformity with regular accounting methods.

We have felt it our duty to protest strongly against the wording of the proposed bill upon the grounds set forth, but our object is to help and not to hinder. If you think any good purpose would be served by our appearing before you and discussing this matter fully with a view to arriving at a satisfactory solution, which we are satisfied can be

done, we shall be pleased to hold ourselves at your disposal for this purpose.

Regretting our inability to in any way modify the conclusions already expressed, We are, Dear Sir,

Yours very truly,

DELOITTE, PLENDER, GRIFFITHS & Co., 49 Wall Street.
PRICE, WATERHOUSE & Co., 54 William Street
HASKINS & SELLS, 30 Broad Street.
LYBRAND, ROSS BROS. & MONTGOMERY, 165 Broadway.
MARWICK, MITCHELL & Co., 79 Wall Street.
NILES & NILES, 111 Broadway.
GUNN, RICHARDS & Co., 43 Wall Street.
EDWARD P. MOXEY & Co., 165 Broadway.
BARROW, WADE, GUTHRIE & Co., 25 Broad Street.
LOOMIS, CONANT & Co., 30 Broad Street.
SUFFERN & SON, 165 Broadway.

The following letter from the Attorney General closed the correspondence:

WASHINGTON, D. C., July 22, 1909.

MESSRS. DELOITTE, PLENDER, GRIFFITHS & Co.,
49 Wall Street,
New York.

DEAR SIRS:—

I have a letter dated the 21st instant, signed by yourself and a number of other firms of accountants, in response to my letter of July 12th, replying to your former letter of July 8th. In your last letter you set forth in somewhat more detail the following proposition:

"But no system of accounting can give even approximately 'the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties.'"

I think the bare statement of that proposition would be received with very great incredulity by most minds. Certainly, I am quite unable to assent to it. However, it is now too late to attempt to recast the corporation tax amendment bill on the basis of such proposition.

Respectfully yours,

(Signed) GEO. W. WICKERSHAM,
Attorney-General.

It is unfortunate that the scientific *income earned* and *expense incurred* basis of determining the net income subject to taxation should have been abandoned for the crude and—as

pointed out in the accountants' letter—unsatisfactory, if not impossible, cash receipts and payments basis, which the Attorney-General states is contemplated by the law. Particularly strange is this, as the framers of the present law had the Act of 1894 to guide them. That act unquestionably contemplated a true income and expense basis of determining the net profits or income, as it stated *inter alia:*

"The net profits or income of all corporations, companies or associations shall include the amounts paid to shareholders, or carried to the account of any fund, or used for construction, enlargement of plant, or any expenditure or investment paid from the net annual profits made or acquired by said corporations, companies or associations."

An examination of the forms required under that act by the Commissioner of Internal Revenue further substantiates this view. The wording of the following items in the form of return are in point:

"1. Gross receipts, credits, earnings and gains from any business. . . .

"2. From interest or coupons, due or paid on any bonds. . . .

"4. From undivided profits of any corporation, company or association.

"8. From interest received or accrued on all notes, bonds, mortgages, or other forms of indebtedness not included in the foregoing items.

"10. From rents received or accrued."

The following items among the "Operating and Business Expenses" likewise show the intention to have the net income ascertained on a scientific basis:

"1. Interest paid or accrued within the year on bonded or other indebtedness.

"7. Cost price of material purchased for manufacture or resale, not increasing stock on hand (at beginning of year)."

It is true that that act, or the interpretation of it, was also open to some criticisms from an accounting standpoint, but not to the same extent as the present law which, instead of being an improvement on the previous act, is the reverse.

Aside from the direct accounting principles involved, one of the most serious objections to the basis prescribed by the law for making returns thereunder is that the returns made will be quite independent of and not at all in agreement with the books of account of the corporations making the returns. Of course, if any corporation should keep its books on a purely cash basis without attempting to determine its actual profit, then its books would, or, rather, should, be in agreement with the government returns. It is doubtful, however, whether the accounting officers of such a corporation (if such a one exists) would know enough to fill out the simplest kind of blanks so that the government officials would probably find quite as much trouble in verifying its returns as may be expected in the case of the ordinary corporation. Hence it will not be possible for the Internal Revenue Commissioner or his agents to verify the returns without exhaustive examination of all the details on which they are based. Even in the case of wilful misstatements it will be extremely difficult, if not in many instances impossible, to prove fraudulent intent, as the excuse of clerical error or mistaken opinion can be pleaded to the limit, there being no permanent records of the corporation to which the returns must conform, as there would be if the returns were required on the same basis on which the accounts of corporations are ordinarily kept.

Government control is being pushed rather far, but one cannot even consider the possibility of corporations being required to keep two sets of books—one to meet the actual necessities of business conditions and the other to satisfy the possible curiosity of an Internal Revenue Collector. Followed out to

its logical conclusion, the collector would have to compare the two sets of books so that in time there would be several hundred thousand inspectors.

At the time of signing the tariff bill the President made the following statement:

"The corporation tax is a just and equitable excise measure, which, it is hoped, will produce a sufficient amount to prevent a deficit, and which, incidentally, will secure valuable statistics and information concerning the many corporations of the country and will constitute an important step toward that degree of publicity and regulation which the tendency in corporate enterprises in the last twenty years has shown to be necessary."

Subsequently, in a speech made at Denver, he stated:

"Another feature of it (the corporation tax law) is that, incidentally, it will give the Federal Government an opportunity to secure most valuable information in respect to the conduct of corporations, their actual financial condition, which they are required to show in general terms in a public return."

And he is also quoted as saying, "It is . . . in effect an income tax—that is, it taxes earnings actually made."

From the letters quoted, it is quite clear that the returns will have little statistical or informative value, as they will not show the true net income of the corporations for any fiscal period, nor will there be any showing of the "actual financial condition" of the corporations, as the only return of that kind called for by the law is a statement of the paid-up capital stock and bonded and other indebtedness, no mention whatever being made of assets or surplus.

If the government is really seeking to secure greater or more effective control of corporations—and the President says this is the case—an excellent opportunity to exercise indirectly effective control of the accounts of corporations is being neglected. The powers to prescribe the form in which the ac-

counts of interstate common carriers shall be kept, to compel the submission of reports prepared therefrom, and to inspect at its pleasure the records kept by carriers, are rightly considered as among the most comprehensive powers enjoyed by the Interstate Commerce Commission. While the submission of reports prepared on a true income and expense basis and for the corporation's fiscal year would not have given the government the same control of the accounting of other corporations as it has of common carriers, it would have resulted in an annual return which would show the real operations of the corporation and one which could be readily verified by reference to the corporation's books of account. Still more important would be the indirect control acquired of the course to be followed with regard to such questions as those of depreciation of property and losses sustained. By providing that only such depreciation and losses as were actually written off on the books would be allowed as deductions from gross income, it would be to the interest of directors to face the facts and take cognizance of them in the corporation's records instead of ignoring them to the ultimate detriment of the stockholders' interests, as has happened in more than one instance in the past. By fixing, on the other hand, maximums of depreciation which would be allowed as deductions in any one year, the possible tendency to write off excessive amounts for depreciation of property, thus reducing the net income on which the tax would be payable and incidentally creating large secret reserves, would be corrected.

Coming finally to the question of how to make the returns required by the law, it may as well be frankly admitted that, as pointed out in the letters of the accountants, it will, in the case of many corporations, be impossible to comply literally with the requirements of the act and that the returns must, therefore, necessarily be only an approximation.

In view of the proposed testing of the constitutionality of the law, it is suggested that all statements, reports and payments (if any) be made under protest.

Insurance Companies: In the case of banks and insurance companies, aside from the unnecessary additional labor involved, there will be little or no difficulty in making a return which will be in precise compliance with the law as interpreted in the Attorney-General's letter. In fact, insurance companies, whose accounting systems are quite crude as compared with those of railroads and industrial corporations, can base their returns on the so-called "Income and Disbursements" statement required by the State Insurance Departments. The following modifications will, however, be necessary:

> Elimination from the "disbursements"—which become "deductions" from the gross income under the wording of the act—dividends paid to or allowed to policy-holders (including the "dividends" of mutual fire insurance companies), and in the case of stock companies dividends paid to stockholders.
>
> Add to the disbursements for the purpose of obtaining the total deductions from the gross receipts which will be allowed—
>
> Additions to the Insurance Reserve *;
>
> Dividends received upon stocks of corporations subject to the corporation tax.

No specific provision is made for the deduction of the amortized premium on bonds, though it might be construed as coming within the scope of "all losses actually sustained within the year." In one sense it may be argued that it is a loss, *viz.*, that the premium is by the effluxion of time disappearing. The fact is that it is being gradually repaid to the investor—in this case the insurance companies—and thus the true net income is not shown until there is deducted from the gross amount of interest received on bonds that portion which repre-

*To judge from the wording of the act, "required by law," the amount of reserves made in excess of the standard required by the State Insurance Departments will not be allowed as a deduction.

sents the partial return of principal, or the premium written off during the year on an amortization basis.

Banks and Trust Companies: In the case of banks and trust companies, from the gross amount of receipts from interest, discount and other sources, there will be deductible expenses and taxes paid, interest on deposits (presumably interest credited to depositors' accounts will be considered as "actually paid"), losses due to uncollectible loans and the like, an allowance for depreciation of banking house and fixtures and dividends received on corporation stocks owned. If real estate, other than the banking house, be owned, it would also be proper to claim deduction for depreciation of any buildings, as well as of any ground, which had depreciated in value.

Mercantile Corporations, whose operations are confined strictly to trading, will find comparatively few difficulties in preparing the returns required. The figures will naturally be worked up from the cash-book, all receipts being carefully scrutinized so as to eliminate from the so-called "gross income" all items which are in the nature of capital receipts, such as additional capital invested, money borrowed, real estate or fixtures sold, investments (if any) matured or sold, etc. The payments will necessarily have to be analyzed so as to state the totals of the various classes of deductions allowed, and to eliminate those items which will not be allowed as deductions from the gross income. This last group will consist of such items as loans repaid, interest on bonded or other indebtedness exceeding the paid-up capital stock of the corporation, dividends paid, etc. To the permissible deductions ascertained from the cash-book will be added an allowance for depreciation of property and any losses sustained which are not represented by payments made in the year. From an accounting standpoint, however, there are certain losses for which credit should not be claimed. Since the "gross income" is to be only that actually collected in cash, losses by bad debts would not be a proper deduction. Depreciation in the value of merchandise would not be a proper deduction, as the entire

cost of merchandise will be claimed as a deduction when purchased.

Transportation and Public Utility Corporations will find their principal difficulty in making returns to lie in the treatment of the payments for stores, *i. e.,* materials and supplies which are not purchased for immediate consumption, but which are added to the stock necessary to be kept on hand and forthwith lose their identity. The subsequent use of the stores at times long subsequent to the date of purchase renders it impracticable, in fact, impossible, to trace most of the stores purchased to their ultimate consumption and thus determine whether the payments therefor are "ordinary and necessary expenses . . . in the maintenance and operation of its business and properties," or are for construction purposes which would not be allowed as a deduction from the gross income receipts. Hence, it follows that a makeshift must be adopted. Two optional courses might be followed; either to analyze all payments for stores, eliminating such as are for articles which it is quite certain will be eventually used for construction purposes, the remaining payments being considered as on account of maintenance or operation, or to deduct from the total payments for stores purchased, the total of stores issued and charged to construction during the year. Either course will not be entirely satisfactory, but over a period of years the latter would give more accurate results. If the former course be followed, many payments will remain in the expense section, which may in part, at least, eventually find their way into construction. This is unavoidable, as so many articles purchased for the storeroom are used for both construction and maintenance purposes.

In any event it will be necessary to analyze all the payments, and, as most companies of this kind charge the bulk of them to Accounts or Vouchers Payable, the voucher register will have to be consulted for the distribution between construction, operation and maintenance, taxes, rentals, interest and stores.

With some companies the distinction between rentals and interest will be a very important one, owing to the limit placed on the amount of debt, the interest on which will be allowed as a deduction from gross receipts. When interest on the bonds of an underlying company is paid in pursuance of a lease by which the parent company pays such interest as a rental of the property, such interest payments should be treated as rental, and the bonded debt of the underlying company would not form a part of the debt on which interest is only allowed as a deduction up "to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation." Where there has been an actual merger, however, and the bonds of one company have been assumed by another, the interest paid thereon would come under the head of interest instead of rentals, and such bonds would be taken into consideration in determining the amount of indebtedness on which interest will be allowed as a deduction from gross income received.

Having analyzed the cash receipts and payments, and ascertained the totals of income receipts and the various classes of payments allowed to be deducted therefrom, it then becomes necessary to consider any other deductions than actual payments which the act may permit to be made. The one which suggests itself perhaps first is depreciation of property, the act providing for the deduction of "a reasonable allowance for depreciation of property." It is to be hoped that this clause of the corporation tax law will give a decided impetus to the recognition of and provision for depreciation of plant. The tendency of many corporations in the past has been rather to ignore depreciation than to make an excessive allowance therefor. Companies operating under limited-term franchises for which value has been paid would also be warranted in deducting a proportionate part of such cost of franchise. Losses "actually sustained" are also to be deducted from gross income received. Judging from the Attorney-General's letter of 12th July, in the case of, say, damages due to accidents, the

deductions should be based on the accidents occurring within the year rather than on damages actually paid, thus getting away from the receipts and payments basis and getting nearer a true income and expense basis. Losses due to bad debts would not be a proper deduction, as only earnings actually collected in cash are included in the "gross income." Whether the amortization of discount on bonds will be permitted to be deducted from gross income may perhaps be disputed. Certainly, from an accounting and common-sense standpoint, it ought to be, as it is, after all, only interest paid in advance.

Manufacturing or Industrial Corporations will find the most difficulty in making a return which will comply even approximately with the intent of the new law as expressed by the Attorney-General. The reasons which render a literal compliance impossible are very clearly and forcibly stated in the accountants' letter of 21st July. Practically all the factors already considered in connection with other classes of corporations will have to be considered. An analysis of all cash receipts and payments will have to be made, eliminating from the receipts everything which is not on income account. From the payments will have to be eliminated all items not applying on income account, such as loans paid off, dividends paid, and all items which can be identified as being clearly construction or plant items. With many companies which have a complete stores system and buy materials and supplies in large quantities, using them for both manufacturing saleable products and additions to plant, as well as manufacturing machinery for their own use, there will be made payments for labor, materials, supplies, etc., the ultimate disposition of which it will be impossible to foretell or trace. With regard to these items, all that can be done is to exercise the best judgment possible and to do it in good faith. The separation must needs be quite arbitrary in many instances, and naturally income should have the benefit of every doubt.

The analysis of the receipts and payments will be followed by the determination of other deductions than actual cash

payments from gross income permitted by the law. Depreciation of property and any losses not represented by actual payments during the year will come under this head. Corporations which have issued bonds at a discount will also need to consider the disposition of the discount, which has already been mentioned.

The blank forms on which the Commissioner of Internal Revenue will require returns to be made have not yet been issued, and probably will not be until 1910, as the first year for which the tax must be paid is the year ending 31st December, 1909. These forms will probably be accompanied by rules to be observed in making the returns. If, however, the methods followed in preparing the forms correspond with the attitude of the Attorney-General (evidenced by his correspondence with the accountants), it may be impossible to even approximate a correct return without prohibitive expense. It is to be expected that, on account of the difficulties mentioned herein and for other reasons, the law will be subjected to judicial scrutiny and interpretation, which may modify materially some of the impressions first created by the law. Certainly, no law which so flagrantly violates the principles of true accounting will stand unchanged for many years.

It is to be hoped, however, that the foregoing criticisms and suggestions will be found interesting and perhaps instructive to the student, even though the act of August 5, 1909, may be materially modified before this volume has been off the press for a month.

Since the foregoing was written, the Treasury Department has issued full instructions covering the returns required, which are reprinted here, with the exception of certain details of interest only to the tax collectors.

It will be noted that the Attorney-General of the United States and the Secretary of the Treasury have arrived at interpretations of the law diametrically opposite to each other. Under the circumstances it will not be strange if accountants and corporation officers arrive at the conclusion that the framers of the law could not possibly have produced more confusion, no matter how hard they tried.

The Treasury Department's Explanation

OF THE

Federal Corporation Tax Law

Regulations Under Which the Law Will Be Administered

Corporation Excise Tax

PREPARATION OF BLANKS AND REGULATIONS.

In the preparation of blanks and regulations for the administration of the Corporation Excise Tax, provided for in section 38 of the tariff act of August 5, 1909, the first question was to ascertain the real intent of the law. After ascertaining the real intent of the law, the problem was then to so prepare the forms and regulations as to carry out that intent and at the same time avoid, as far as consistent, unnecessary and unreasonable interference with ordinary practices of business. The standard adopted in making the regulations was that they

should be fair, just, and reasonable to the taxpaying corporations as well as to the Government.

A study of the act discloses clearly that the intent of the law is as follows:

1. That the law is a revenue measure and should be construed liberally for the purpose of producing revenue for the Government.

2. That the real intent of the law is to collect a tax of 1 per cent on the *net income,* less $5,000 of the individual corporation, joint-stock company, or association liable to the tax.

In order to clearly understand the intent of the law a few primary definitions are essential:

NET INCOME.

The term "net income" as used in this law means not only net profits arising from the operation of the principal business of the corporation, but all items of income received from other sources, such as investments, holdings in other companies, and businesses, etc. The expression "net income" is used because there can be no question as to its embracing amounts of income received from these outside sources, whereas there might be some question as to whether or not such items would be included in the expressions "net profits" or "net earnings."

GROSS INCOME.

In the same manner the term "gross income" includes gross profits, the expression being used because there can be no question but what it embraces all items of income received by any corporation from any source, while there might be some question as to whether "gross profits" or "gross earnings" would embrace such items.

A great amount of adverse criticism of this law is due to misapprehension of the proper definitions of these terms. The opinion was advanced that because "gross income" was not "gross profits" it must be "gross receipts," and that, in the

same way, because "net income" was not "net profits" it meant "net receipts." An examination of the law, however, will show that if gross income meant gross receipts the statutory deductions therefrom would not leave net receipts, but would leave merely an arbitrary sum. It also appeared from calculations that if these interpretations were given to the law from mercantile and manufacturing companies alone the amount of tax received would be many times the sum which was estimated to be collected from all corporations, joint-stock companies, and associations of whatever nature.

It is clear, therefore, that the purpose of the law was not to put a tax on receipts, but a tax on profits; and that the terms "gross income" and "net income" are used because, while they are practically identical with "gross profits" and "net profits," they are yet more embrasive and consequently permit a more comprehensive administration of the law.

The law requires that the return from every corporation, joint-stock company, and association liable to the tax shall show the "gross amount of the income * * * received during the year from all sources," and authorizes certain deductions such as "ordinary and necessary expenses actually paid out of earnings in the business and property of such corporations * * * within the year; all losses sustained during the year; amount of interest actually paid within the year; amount paid by it within the year for taxes; amount received within the year as dividends upon stock of other corporations liable to this tax, etc."

Very careful consideration has been given to these expressions in order to determine what evidence shall be required in order to determine what items are to be considered as "income" in calculating "gross income," and what items should be allowed as deductions under the language of the law. An impression has obtained in some quarters that no item should be considered in making up the account of the corporation, either as income or a deduction, unless its receipt or disbursement was evidenced by an actual cash transaction. It was owing to this interpretation placed on the law that a

great number of accountants throughout the country declared that the law was impossible of administration, and if their interpretation of the law had been correct, there would indeed have been the most serious difficulty.

Upon first reading the law and studying the authorities relating to the language used, it would appear that the words admit of no interpretation other than that an item must have been evidenced by the actual disbursement of cash, or something of equal value, before it could be considered in making up the account of a corporation. It is interesting to note, however, that all definitions and decisions regarding the expression "actually paid," consider the matter from the standpoint of debtor and creditor, and not from the standpoint of the individual himself, or in this case, from within a corporation concerned solely with its own accounts from which alone the law requires this return for taxation to be made, and not taking into consideration the standpoint of the debtor.

It is clear that to hold that the phrase "actually paid within the year" requires evidence of actual disbursement in cash during the year would prohibit anything like accurate returns being made by any corporation, and would render it impossible to carry out what is the main purpose of the law, because to subtract from the gross income the deductions specified in the statute, calculated on a cash basis, would give net income, on which the tax is to be measured, only when the entire business transacted by the corporation is done in cash and the transactions are completed every day. It is not believed that there is any such corporation in existence. The return, predicated on gross income received in cash and deductions represented by cash transactions will vary from the real net income somewhat in proportion as the business transacted by the corporation varies from the absolutely cash basis.

This is viewing the matter in its simplest aspect. When we contemplate the complications and intricacies of the business affairs of a great corporation, with its many dealings with other corporations and individuals which are never settled in cash, but are settled on somewhat the clearing-house plan;

its many advances of funds and long-deferred statements of accounts, purchases of supplies and materials at one time, which are mixed with supplies and materials already on hand and those purchased at other times, and which are used and disbursed without any relation to their time of purchase, any attempt to follow each of these transactions out into the cash-book and to settle the accounts of such complicated actions of a corporation on the cash book instead of on the ledger, would result in inextricable confusion, uncertainty, and inaccuracy, and the friction occasioned the business world by such an attempt would be a very serious proposition.

Relating to statutory deductions, the regulation is to the effect that the deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered as such on its books from January 1 to December 31 of the year for which return is made. It will appear, therefore, that the return is to be made up from the ledger and not the cash book, and that entry on the ledger from January 1 to December 31 of the year for which return is made is the evidence which will determine whether or not an item is to be taken account of in making the return.

It is believed that this interpretation furnishes a practical working method by which the amount of income subject to the tax can be fairly and justly determined in every case.

Of course, in administering a law applying to so many taxpayers (lists prepared by collectors show something over 400,000 corporations which will have to make returns) some of the returns will be inaccurate. The causes of inaccuracy will be two: First, honest error; second, wilful intent to defraud the Government of revenue. If an honest error is made in calculating the return for one year, it will be corrected if possible, and even if not corrected in one year it would more than probably correct itself later. Where fraudulent purpose is discovered, vigorous prosecution will follow. This bureau feels that in dealing with the incorporated business of the country it is dealing, in the main, with honest men. However,

the regulations are drawn sufficiently rigid to restrain anyone who does not measure up to this standard.

The regulations do not call for specific methods of keeping accounts or any particular method of bookkeeping; the requirement is simply that the transaction be so recorded that accurate returns can be made therefrom and verified when necessary.

In many corporations, mercantile and manufacturing particularly, an inventory, or its equivalent, is essential at the close of each calendar year. The law specifically states that the tax shall be collected for the calendar year and no return for any other period can be accepted. Provision is, however, made for preparing returns for the present year, when no inventory or equivalent was taken at close of last calendar year. Provision is made for a method of fairly determining amount of loss and depreciation claimed; also for a fair adjustment of profit or loss in case of sale of capital assets acquired prior to January 1, 1909; also for properly accounting for materials and supplies, etc.

Great numbers of communications have been received relative to the publicity clause. While there is apparently some inconsistency between the two paragraphs of the law relating to making public the information received, the language of the law relating to filing returns for record and public inspection is so clear that the Bureau of Internal Revenue has no discretion whatever in the matter.

The forms and regulations will go to the collector of each district, who will send copies of the blanks and a copy of the regulations to every corporation whose name and address the collector has been able to secure. Failure to receive the blanks or any notice relative thereto will not excuse a corporation from making the return required by law, nor will it relieve it from penalties for failure so to do. If copies of blanks and regulations are not received on or about January 1, application should be made to the collector in whose district the prinicipal office of the corporation is located, so that the return can be in the hands of the collector by the time required in the statute.

The regulations issued by the Commissioner of Internal Revenue are as follows:

REGULATIONS

Relative to

Excise Tax on Corporations, Joint Stock Companies, Associations and Insurance Companies.

Imposed by authority of Section 38, Act of August 5, 1909.

ARTICLE I.

The attention of collectors and others is specially called to the fact that the tax imposed by this section of the law applies to all corporations, joint-stock companies, associations, or insurance companies described (except those specifically exempted), without reference to the kind of business carried on, and that the tax is to be computed upon the NET INCOME of such corporations, joint-stock companies, associations, and insurance companies, which shall be calculated by subtracting from the gross income received from all sources during the year certain deductions specifically set forth in the statute.

Every corporation, joint-stock company, association, or insurance company not specifically enumerated as exempt shall make the return required by law, whether it may have net income liable to tax or not.

In the case of corporations, joint-stock companies, associations or insurance companies organized under the authority of the United States or any State or Territory thereof, including Alaska and District of Columbia, such net income relates not only to the business carried on within the confines of the United States, but to income received from business transacted in any foreign country as well. In case of corporations, joint-stock companies, and associations organized under the authority of foreign countries the terms " Gross income," " Net income," and " Authorized deductions " relate only to business transacted within the United States or any state or territory thereof.

ARTICLE 2.—*Gross Income.*

The following definitions and rules are given for determining the gross income of the various classes of corporations:

1 A. *Banks and other financial institutions.*—Gross income consists of the gross revenue derived from the operation and management of the business and property of the corporation making the return, together with all amounts of income (including dividends received on stock of other corporations, joint-stock companies, associations, and insurance companies subject to this tax) derived from all other sources, as shown by the entries on its books from January 1 to December 31 of the year for which return is made.

1 B. *Insurance companies.*—Same as I A above.

2. *Transportation companies.*—Same as 1 A above.

3. *Manufacturing companies.*—Gross income received during the year from all sources will consist of the total amount, ascertained through an accounting, that shows the difference between the price received for the goods as sold and the cost of such goods as manufactured. The cost of goods manufactured shall be ascertained by an addition of a charge to the account of the cost of goods as manufactured during the year of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year. To this amount should be added all items of income received during the year from other sources, including dividends received on stock of other corporations, joint-stock companies, associations, and insurance companies subject to this tax. In the determination of the cost of goods manufactured and sold as above such cost shall comprehend all charges for maintenance and operation of manufacturing plant, but shall not embrace allowances for depreciation of property nor for losses sustained which are to be taken account of in ascertaining the net income subject to tax under the proper heading in the authorized deductions.

4. *Mercantile companies.*—Gross amount of income received during the year from all sources consists of the total amount

ascertained through inventory, or its equivalent, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge to the account of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year. To this amount should be added all items of income received during the year from other sources inclusive of dividends received on stock of other corporations, joint-stock companies, associations, and insurance companies subject to this tax. In determining this amount no account shall be taken of allowances for depreciation of property, nor for losses sustained which are to be taken account of in ascertaining the net income subject to tax under the proper heading in the authorized deductions.

5. *Miscellaneous.*—Gross income consists of the gross revenue derived from the operation and management of the business and property of the corporation making the return, together with all amounts of income (including dividends received on stock of other corporations, joint-stock companies, associations, and insurance companies subject to this tax) derived from all other sources as shown by the entries on the books from January 1 to December 31 of the year for which return is made.

It will be noted from these definitions that gross income is practically the same as gross profits, the only difference being that gross income is more inclusive, embracing as it does not only gross profits of the corporation, joint-stock company and association itself, but also all amounts of income received from other sources. It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as to entitle it to proper entry on the books of the corporation from January 1 to December 31 for the year in which return is made.

Sale of capital assets.—In ascertaining income derived from the sale of capital assets, if the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income

to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion shall be deducted from or added to the gross income for the year in which the sale was made. But for the purpose of determining the selling price, as provided in this section, there shall be added to the price actually realized on sale any amount which has already been set aside and deducted from gross income by way of depreciation as defined in article 4, and has not been paid out in making good such depreciation on the property sold.

Where a corporation is engaged in carrying on more than one class of business, gross income derived from the different classes of business shall be ascertained according to the definitions above, applicable thereto.

Article 3.—*Net Income.*

"Net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest

actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint-stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association, or trust company, all interest actually paid by it within the year on deposits." In case of corporations, joint-stock companies, and associations organized under the laws of a foreign country, "the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein; (fifth) all amounts received by it within the year as dividend upon stock of other corporations, joint-stock companies or associations, or insurance companies, subject to the tax hereby imposed."

The section further provides:

That in the case of a corporation, joint-stock company, or association, or insurance company, organized under the laws of a foreign country, such net income shall be ascertained (by making like deductions) from the gross amount of its income received within the year from business transacted and its capital invested within the United States and any of its Territories, Alaska, and the District of Columbia.

Also that:

In the case of assessment insurance companies the actual deposit of sums with state or territorial officers, pursuant to law, as additions to guaranty or reserve fund, shall be treated as being payments required by law to reserve fund.

Also (third paragraph) that:

There shall be deducted from the amount of the net income

of each of such corporations, joint-stock companies, or associations, or insurance companies, ascertained as provided in the foregoing paragraphs of this section, the sum of five thousand dollars.

The net income, therefore, is the remainder of the gross income after making the specified deductions.

Article 4.—*Deductions.*

The specified deductions actually paid within the year, set forth in the statute and as described in Article 3 preceding, shall include all proper items of expenses and charges under the respective heads as designated. The amount returned for ordinary and necessary expenses actually paid within the year out of income in maintenance and operation of the business and properties of the corporation should not, however, embrace allowances for depreciation of fixed property which are otherwise to be taken account of under the proper heading in the authorized deductions, nor expenses paid within the year and charged to such allowances for depreciation credited in the current year or in previous years. In ascertaining expenses proper to be included in the deductions to be made under this article, corporations carrying materials and supplies on hand for use should include in such expenses the charges for materials and supplies only to the amount that the same are actually disbursed and used in operation and maintenance during the year for which the return is made.

It is immaterial whether the deductions are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books as to constitute a liability against the assets of the corporation, joint-stock company, association, or insurance company making the return.

Losses.—The deduction for losses must be in respect of losses actually sustained during the year and not compensated by insurance or otherwise. It must be based upon the difference between the cost value and salvage value of the property

or assets, including in the latter value such amount, if any, as has in the current or previous years been set aside and deducted from gross income by way of depreciation as defined in the following section and not been paid out in making good such depreciation.

Depreciation.—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use. Expenses paid in any one year in making good exhaustion, wear and tear, or obsolescence in respect of which any deduction for depreciation is claimed must not be included in the deduction for expense of maintenance and operation of the property or in the ascertainment of gross income, but must be made out of accumulative allowances deducted for depreciation in current and previous years.

Article 5.—*Inventories.*

It will be noted that an inventory or its equivalent of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year is essential in the case of certain corporations in order to determine the gross income, and in case of other corporations to determine their expenses of operation. Where such inventory or its equivalent was not taken at the close of the year 1908, a supplemental statement showing such inventory approximately must be submitted with the return on the regular form. Such supplemental statement shall be verified under oath by the treasurer or principal financial officer in submitting the same.

Where any item under any of the deductions is of an un-

usual nature a special explanatory note referring to such item shall be made and attached to the form at the appropriate place and made a part thereof by proper reference.

Paragraph 3 of said Section 38 also provides:

and said tax shall be computed upon the remainder of said net income of such corporation, joint-stock company or association, or insurance company, for the year ending December thirty-first, nineteen hundred and nine, and for each calendar year thereafter; and on or before the first day of March nineteen hundred and ten, and the first day of March in each year thereafter, a true and accurate return under oath or affirmation of its president, vice-president, or other principal officer, and its treasurer or assistant treasurer, shall be made by each of the corporations, joint-stock companies or associations, and insurance companies, subject to the tax imposed by this section, to the collector of internal revenue for the district in which such corporation, joint stock company or association, or insurance company, has its principal place of business, or, in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, in the place where its principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe.

Each return so made is required to set forth:

(*a*) The total amount of the paid-up capital stock of such corporations, joint-stock companies or associations, or insurance companies, outstanding at the close of the year;

(*b*) The total amount of bonded and other indebtedness of such corporation, joint-stock company or association, or insurance company, at the close of the year;

(*c*) The gross amount of the income of such corporation, joint-stock company or association, or insurance company, received during the year from all sources, and if organized under the laws of a foreign country, the gross amount of its income received within the year from business transacted and capital

invested within the United States and any of its territories, Alaska, and the District of Columbia.

Such returns are also required to set forth the items claimed as deductions (Article 4), also the net income after such deductions have been made.

Article 6.

Under the authority conferred by this act forms of return have been prescribed, in which the various items specified in the law are to be stated.

Blank forms of this return will be mailed to collectors and should be furnished to every corporation, not expressly excepted, on or before January 1, 1910, and on or before January 1 of each year thereafter. Failure on the part of any corporation, joint-stock company, association, or insurance company liable to this tax, to receive a blank form will not excuse it from making the return required by law, or relieve it from any penalties for failure to make the return in the prescribed time. Corporations not supplied with the proper forms for making the return should make application therefor to the collector of internal revenue in whose district is located its principal place of business. Each corporation should carefully prepare its return so as to fully and clearly set forth the data therein called for.

Bookkeeping.—No particular system of bookkeeping or accounting will be required by the Department. However, the business transacted by corporations, joint-stock companies, associations, or insurance companies must be so recorded that each and every item therein set forth may be readily verified by an examination of the books and accounts, where such examination is deemed necessary.

Calendar year.—As the law specifically provides that the tax imposed shall be computed on the net income during each "*calendar* year," returns of income based on any period other than the calendar year can not be accepted.

Corporations organized during the year or going into liquidation during the year should nevertheless render a sworn return on the prescribed form.

ROYAL E. CABELL, *Commissioner.*

Approved:

FRANKLIN MACVEAGH,
Secretary of the Treasury.

INDEX.

Accountants, Opinion of, on extent of investigations, 319
Accounts, Corrections in, 31
" of Architects, Points in the audit of, 165
" Banks, Points in audit of, 114
" Branch Establishments, 82
" Breweries, Points in audit of, 96
" Building and Loan Societies, Points in audit of, 161
" Cash Businesses, Points in audit of, 93
" Churches, Points in audit of, 159
" Clubs, Points in audit of, 99
" Colleges and Schools, Points in audit of, 160
" Collieries, Points in audit of, 109
" Commercial, 91
" Consignments, 81
" Contractors, Points in audit of, 95
" Cost, 59
" Electric Lighting Bodies, Points in audit of, 141
" " Railways, Points in audit of, 146
" Executors and Trustees, Points in audit of, 155
" Financial Undertakings, Points in audit of, 114
" Fire Insurance Companies, Points in audit of, 122
" Gas Companies, Points in audit of, 139
" Gold Mines, &c., 112
" Hotels, Points in audit of, 98
" Institutions, Points in audit of, 158
" Insurance Companies, Points in audit of, 121
" Investment Companies, 126
" Lawyers, Points in audit of, 164
" Life Insurance Companies, Points in audit of, 124
" Manufacturing Traders, Points in audit of, 92
" Medical Men, Points in audit of, 160
" Merchants, Wholesale, Points in audit of, 91
" Mines, Points in audit of, 109
" Newspapers, Points in audit of, 107

Accounts of Public Authorities, Points in audit of, 152
" Public Service Corporations, Points in audit of, 132
" Publishers, Points in audit of, 105
" Railways, Points in audit of, 142
" Restaurants, Points in audit of, 99
" Retailers, Points in audit of, 92
" Shipping Companies, Points in audit of, 150
" Single-ship Companies, Points in audit of, 152
" Speculative Finance Companies, Points in audit of, 132
" Steam Railways, Points in audit of, 143
" Street Railways, Points in audit of, 145
" Stockbrokers, Points in audit of, 129
" Stores and Stock, Points in audit of, 71
" Theatres, Points in audit of, 101
" Theatrical Companies, Points in audit of, 103
" Traders, Points in audit of, 73, 211
" Trust and Investment Companies, Points in audit of, 126
" Water Companies, Points in audit of, 141
" Published form of, Auditor's duty as regards, 206, 239
Action against auditors, Procedure by way of, 310
Additions and betterments expenditures, Steam Railways, 143
" Checking, 32
Adjustments of profits in investigations as to profits, 322
Advantages of a "completed audit," 28
" "continuous audit," 28
" an audit, 25
" double-entry bookkeeping, 246
" keeping proper Stock Accounts, 71
" making each Ledger self-balancing, 66
" opening Suspense Accounts, 76
" statistical information, 215
" Tabular Cash Book, 60
" use of an Audit Note Book, 17
After discovered evidence, 205
Agency Accounts, Treatment of, 81
Agents' Accounts, 80
Agreement, Partnership, Points to be considered in drawing up, 85
Agreements, Hire-Purchase, 185
" Partnership, 85
Alterations during audit, Methods of detecting fraudulent, 45
Amateur auditors, 266
American Malting case, 180, 250, 386
Amortization, 50
Amount of reserve necessary for insurance company, 122

Annuity system of depreciation, 190
Annuity Tables, Charles E. Sprague on, 190
Anticipated Profits, 181
Appleton v. American Malting Company, case considered, 250
Apportionment between capital and revenue, Examples of, 136
" of capital and income in Executorship Accounts, 155
Architects, Accounts of, Points in audit of, 165
Arrears of cumulative preference dividends, Treatment of, 184
Assets and liabilities, Reason for transposing in Balance Sheet, 217
" " secret reserves, Fluctuations in, 203
" Auditor's duty with regard to writing-up of, 203
" Definition of term, 216
" in books of account, Methods of depreciating, 187, 217
" Legality of writing-up, 203
" of bank, Method of vouching, 114
" Outstanding, Verification of, 182
" Principle in valuation of, 169, 225
" Side of Balance Sheet, 220
" Verification of existence of, 114, 174
Astrachan Steamship Company, case considered, 311
Attorney-General of U. S. Correspondence *re* Corporation Tax, 549
Audit, system of conducting an, 17
" clerks, Qualifications of, 275
" completed, Disadvantages of a, 28
" continuous, Description of, 28
" " Disadvantages of a, 28
" Detection of fraud as an object of an, 22
" fee, Treatment of, in accounts, 184
" Importance of ascertaining general system under, 24
" Instructions as to preparation for, 88
" " for, 20
" Limitation of, 270
" Method of an, 28
" New, Duties of principal at commencement of, 21
" not an insurance against fraud, 270
" Note Book, description of, 17, 19
" " " form of, 18
" Object and scope of an, 22
" of brewery, saloons in connection with, 97
" Capital Stock Accounts, 49
" Corporations Accounts, 48
" payments for dividend or interest, 51
" Purchase Ledgers of retailer, 93
" railway, Programme of, 145
" Sales Ledgers of retailer, 92

Audit of trust companies, Valuation of investments in, 121
" Stamps, Rubber, 42
" System on which, should be conducted, 17
Auditing, examination questions, 510
Auditor, Liability of, with regard to predecessor's errors, 33
" of a bank, Liability of, 114
" " company, Position of an, 26
" on behalf of creditors, Position of, 278
" Position of, who disagrees with directors, 284
" Qualifications of an, 274
" Removal of, how effected, 284
" Responsibility of, for errors, 299
" Right of, as to resignation, 282
" to a firm, Position of, 277
" " an individual, Position of, 276
Auditor's duties, 292
" duty as regards examination of Pass Books in bank audit, 118
" " " " form of published accounts, 206, 239
" " " " individual partners, 277
" " " " secret reserves, 204
" " " " *ultra vires* Acts, 205
" " " " valuation of stock-in-trade, 174
" " " to verification of cash in hand, 301
" " " " public, 126
" " who is refused permission to inspect Minute Book, 202
" " with regard to book debts, 176
" " " " writing up of assets, 204
" examination of the books, Extent of, 23
" liability for defalcations of employees, 290
" " Limits to, 311
" position, 276
" responsibility for values, Decision in *London and General Bank* case, 173, 358
" right of inspection of Minute Book of company, 201
" " to his remuneration, 276
Auditors, Amateur, 266
" Civil liability of, 309
" Criminal liability of, 307
" Distinction between various classes of, 266
" Duties of, 285
" in the 13th Century, 537
" Liabilities of, 290
" Liability of, for libel, 305
" Methods of proceeding against, civilly, 309
" Official, 271

Auditors, position under English Companies Act, 286
" "Privilege" of, 283, 306
" Procedure by way of action against, 309
" Professional, 269
" Rights of, 285
Bad and doubtful debts, Provision for, 196
" " " " Treatment of, 77
" debts, Extract from *Accountant* on provision for, 197
" " in investigations as to profits, Method of dealing with, 332
" " Methods of providing for, 77
" " Provision for, by percentage of sales, 78
" figures in accounts, 31
Balance Sheet, Comparison of Ledgers with previous, 32
" " Consolidated, 239
" " Criticism of American, 221
" " Forms of, 217, 411, 427, 430, 436, 454, 459, 463, 484-492
" " Principles of compiling a, 169
" " Reason for transposing liabilities and assets in, 217
" " Responsibility for values in, 173
" Sheets in investigations, Necessity of inspecting, 327
Balances, Necessity for checking starting, 32
Balancing books, Importance of, exactly, 46
" Methods of, 46
Bank Account, Method of vouching, 40
" assets of, Method of vouching, 114
" auditor of a, Liability of, 114
" balance, Verification of, 177
" borrowers' statements, Forms, 409, 495
" charges, Advisability of checking, 62
" Pass Book, English system contrasted with American, 40
" " " Ideal way of writing up, 40
" " " Method of checking, with Cash Book, 40, 122
" Points in Revenue Account of, 119
" Reports, national, Forms, 404, 455
Bankers' credit information committee report, 26
Banks, accounts of, Points in audit of, 114
" certified borrowers' statements for, 26
" Corporation Tax Law, 562
" methods of computing interest, 342
Beneficiaries, Procedure on division of estate between, 155
Bills of exchange, Method of vouching, 43
" receivable, Examination of, 44
" " Verification of, 179
Bonds in Balance Sheet, Treatment of, 225, 230
" Treatment of, discount on, 50

Book debts, Auditor's duty with regard to, 176
" " Verification of, 176
Bookkeepers, Instructions for, 57
Bookkeeping by Card system, 70
" Criticism of card, 71
" Double-entry, Advantages of, 246
" Loose-Leaf system of, 70
Borrowers' statements, Forms, 409, 495
Branch Accounts of banks, Extent of auditor's examination of, 114
" establishments, Accounts of, 82
" " Stock Accounts in, 84
Breweries, accounts of, Points in audit of, 96
Brewery, audit of, Saloons in connection with, 97
" plant, Depreciation in connection with, 97
Building and Loan Associations, Accounts, Frauds in, 161
" " " " Forms, 405, 459
" " " " Points in the audit of, 161
Buildings and land, Verification of, 190
" Depreciation of, 190
Burleigh, Herbert Alfred v. Ingram Clark Lim., Decision in, 374
By-Laws, Necessity of perusing, 53
Calculating interest, rules for, 342
Calling back postings, 29
Cancellation of vouchers, 42
Capital and income in Executorship Accounts, Apportionment of, 155
" " revenue, Distinction between, 85, 109, 136, 142, 144
" " " Examples of apportionment between, 137
" expenditure, Treatment of discounts on, 61
" in Balance Sheet, Treatment of, 230, 247
" Stock accounts, 75
Capital Stock Accounts, audit of, 49
Capitalization of preliminary expenses, 171, 200
Car Trust Bonds, Treatment of, 185
Card bookkeeping, 70
Cash and trade discount, distinction to be made between, 198
" Book, Form of 60
" " Method of checking Bank Pass Book with, 39
" " Tabular, Advantages of, 60
" businesses, Accounts of. Points in audit of, 94
" in hand, Auditor's duty as to verification of, 303
" " Decision, with regard to verification of, 373
" " Verification of, 178, 303
" receipts, Method of vouching, 34
Certificate after investigation, Extent of, 316, 325, 338
" of incorporation, Necessity of perusing, 53

Certifi ation, Extent of auditor's, 290
" Legislative requirement, 280
C. P. A. examination questions, 510
Charitable institutions, Accounts of, Points in the audit of, 158
Charter, necessity of perusing, 53
Checking additions, 32
Churches, accounts of, Points in the audit of, 159
City accounts, Forms, 410, 421, 497
Civil liability of auditors, 309
Clerks, Qualifications of, 275
Clubs, accounts of, Points in audit of, 99
Coal mines, accounts of, Points in audit of, 109
Code of professional ethics, 380
Colleges and schools, accounts of, Points in the audit of, 160
Columnar Cash-book, advantage of, 60
Commercial Law, examination questions, 511
Commission on the underwriting or placing of shares, 49
" profits from, Treatment of, on underwriting shares, 259
Companies (English) Act, extracts from, 253, 286
Comparative Depreciation Table, 189
Comparison of Ledgers with previous Balance Sheet, 32
" Revenue Accounts in investigations as to profits, 329
"Completed audit," Advantages of a, 28
" " Disadvantages of a, 29
Confirmation of customers' accounts, 37, 117
Consignment Accounts, 81
" " Method of vouching, 45
Consolidated Balance Sheets and Profit and Loss Statements, 239
" " " A. Lowes Dickinson's opinion on, 239
Contingent assets in Balance Sheet, 229
" liabilities in Balance Sheet, Treatment of, 238
" " Verification of, 184
"Continuous audit," advantages of a, 28
" " description of, 28
" " disadvantages of a, 28
Continuing Partners, duties of, 337
Contractors, Accounts of, Forms of, 214
" " Points in audit of, 95
Contracts, Uncompleted, Valuation of, 180
Conversions, Treatment of expenditure on, 139
Cooper, John A., Code of Ethics, 380
Copyrights, Depreciation of, 195
" Valuation of, 106
Corporation Accounts, audit of, 48
" Tax Law, U. S. (1909), 540

Corrections in accounts, 31
Cost Account of shipping company, Meaning of, 151
" Accounts, 59
" " Necessity of having proper, 59, 95, 214
Coupon Accounts, 52
Coupons, Method of filing cancelled, 52
Creditors, Position of auditor on behalf of, 278
Criminal liability of auditors, 307
Criticism of American Balance Sheets, 221
" Card Bookkeeping, 70
Current assets, 170, 172, 221
Customers' accounts, Manipulation of, 35
" " Verification of, 37
"Dating forward," Danger of, invoices for purchases, 185
Dead or minimum rents in Mining Accounts, Definition, of 110
Debts, book, Auditor's duty with regard to, 176
" Ledger, Doubtful, Explanation, of, 78
" owing to company, Treatment of, in Balance Sheet, 223
Decision in *American Malting* case, 251
" " *Appleton v. American Malting Company*, 250
" " *Dovey and others v. Cory*, 248
" " *Dumbell's Banking Company, Lim.*, 308
" " *Foster v. The New Trinidad Lake Asphalte Company, Lim.*, 249
" " *Herbert Alfred Burleigh v. Ingram Clark, Lim.*, 374
" " *Lee v. Neuchatel Asphalte Company, Lim.*, 247
" " *London and General Bank* case as to auditor's responsibility for values, 173, 358
" " *London Oil Storage Company, Lim., v. Seear, Hasluck & Co.*, with regard to verification of cash in hand, 373
" " *Lubbock v. The British Bank of South America, Lim.*, 248
" " *Martin v. Isitt*, 299, 374
" " *Moxham and others v. Grant*, 313
" " *Newton v. Birmingham Small Arms Co., Lim.*, 377
" " *Richardson v. Buhl*, 257
" " *Short & Compton v. Brackett*, 319, 372
" " *Smith v. Sheard*, 376
" " *The Astrachan Steamship Company, Lim., and others v. Harmood-Banner & Son*, 311
" " *The Edinburgh United Breweries, Lim., v. James A. Molleson (Nicholson's Trustee)*, 317
" " *The Irish Woollen Company, Lim., v. Tyson*, 367
" " *The K ngston Cotton Mill Company, Lim.*, 363
" " *The Leeds Estate Building and Investment Society, Lim., v. Shephard*, 310, 358
" " *Wilde and others v. Cape & Dalgleish*, 299, 367

Decision in *Wilmer v. McNamara & Co., Lim.*, 248
Defalcations of employees, Auditor's liability for, 299
Definition, Buckley's, of term "profits," 254
" of depreciation, 187
" minimum or dead rents in Mining Accounts, 110
" term "assets," 216
" " "profits," 253, 254, 391
" " "Reserve Fund," 228
" vouching, 34
" words "sale as a going concern," 169
Departmental Accounts, 94
" Ledger, 67
Depositors' Pass Books, Inspection of, 117, 120
Depreciating assets in books of account, Methods of, 187, 217
Depreciation allowed for in Electric Lighting Accounts, Instances of, 142
" and fluctuation in values, Distinction between, 171, 187
" Annuity system of, 190
" Definition of, 187
" Fund necessary where company holds lands on lease, 140
" in connection with brewery plant, 97
" Instalment system of, 190
" investigations as to profits, Method of dealing with, 331
" Necessity of providing for, 217
Depreciation of copyrights, 195
" buildings, 190
" electric lighting plant, Necessity of increased, 142
" " Railways, 147
" furniture, 194
" goodwill, 190
" horses, 191
" investments, 191
" landlord's fixtures, 196
" lands, 189
" leasehold land and premises, 191
" leases, 66
" licensed houses, 192
" machinery, 192
" mines, 112, 193
" patents, 194
" plant, 194
" " under hire-purchase agreements, 186
" ships, 195
" street railway companies, 147
" theatrical plant, 195
" Sinking fund system of, 188

Depreciation of table, Comparative, 189
Detection of errors in books in investigations, 317
" fraud as an object of an audit, 22
" " in investigations, 322
Devising system of books, Points to be considered in, 55
Dickinson, A. Lowes, Introduction, 11
" " Consolidated Balance Sheets, 239
" " Exhaustion of Minerals, 112
" " Marketable Investments, 224
" " Sinking Funds, 229
" " Stocks on hand, 221
Dilapidations to be considered in depreciation of leasehold premises, 191
Directors' fees, Vouching of, 199
Directors, Position of auditor who disagrees with, 285
Disagreement of auditor with directors, 285
Discount and interest, Treatment of, 50, 61, 342
Discounts, Method of providing for outstanding, 198
" on capital expenditure, Treatment of, 62
Dividends or interest, Audit of payments for, 51
" out of capital, What is payment of, 247
" regulations respecting same in English Companies Act, 253
" to be paid only from earnings or surplus, 247
" Treatment of arrears of cumulative preference, 184
Double entry bookkeeping, Advantages of, 246
Doubtful, and bad debts, Provision for, 196
" " " " Treatment of, 77
" Debts Ledger, Explanation of, 77
Dovey v. Cory, case considered, 248
Dumbell's Banking Company, Lim., case considered, 308
Duties of auditors, 23, 119, 285
" liquidating and continuing partners, 337
" official auditors, 271
" principal at commencement of new audit, 21
Edinburgh United Breweries, Lim., &c., v. James A. Molleson, case considered, 317
Electric Light, Heat and Power Companies, Forms, 400, 427
Electric Lighting Accounts, depreciation allowed for in, 142
" " " Points in audit of, 141
" Railways, Depreciation of, 147
" " Forms, 399, 422
" " Points in audit of, 146
Employees, defalcations of, Auditor's liability for, 299
Errors, Localizing, 47
" Responsibility of auditors for, 307
Ethics, Code of Professional, 380

Ethics, Rules, 384
Examination questions, C. P. A., 510
Executors and trustees, accounts of, Points in audit of, 155
Executorship Accounts, Apportionment of capital and income in, 155
Expenditure on conversions, Treatment of, 139
" " new works, in place of old, Treatment of, 137
Expenses, Distinction between various classes of, 260
" of revenue, 260
" which may be spread over a number of years, 260
Extent of an auditor's examination of the books, 23
" auditor's certification, 290
" certificate after investigation, 316, 324, 337
" investigations as to profits, 316
Fees, directors', Vouching of, 199
Figures, Bad, in accounts, 31
Finance companies, speculative, accounts of, Points in audit of, 126
Financial undertakings, accounts of, Points in audit of, 114
Fire Insurance Companies, accounts of, Points in audit of, 122
Firm, Position of auditor to a, 277
Fixed and floating assets, Distinction between, 170
" assets in Balance Sheet, Treatment of, 220
" " Definition of, A. L. Dickinson, 224
" " Valuation of, 171, 263
Fixtures, landlord's, Depreciation of, 196
Floating and fixed assets, Distinction between, 171
" assets in Balance Sheet, Treatment of, 221
" " Valuation of, 172, 263
Fluctuation and depreciation in values, Distinction between, 171, 187
" in assets and secret reserves, 203
" of values in accounts, Treatment of, 187
Foreign exchanges, Treatment of, 204
Forfeited shares, 202
Form of Audit Note Book,
" Balance Sheet, 208
" Cash Book, 60
" published accounts, Auditor's duty as regards, 206, 239
" Revenue Account for traders considered, 209
" for Borrowers from Banks, 409, 495
" " Building and Loan Associations, 405, 459
" " Electric Light, Heat and Power Companies, 400, 427
" " Electric Railway Companies, 399, 422
" " Gas Companies, 401, 436
" " Insurance Companies, 405, 463
" " Municipal Reports, 410, 421, 497
" " National Bank Reports, 404, 455

Form of Public Service Corporations, 399, 421
" " Steam Railroads, 396, 411
" " Water Supply Enterprises, 401, 441
Forms of accounts for contractors, 214
" " manufacturers, 212, 407, 484
" " mines, 215
" " traders, 211, 408, 492
Foster v. The New Trinidad Lake Asphalte Co., Ltd., decision, 249
Fraud, Audit not an insurance against, 271
" Detection of, as an object of an audit, 22
" in investigations, Detection of, 322
Fraudulent alterations during audit, Methods of detecting, 43
Funds, meaning of word, 232
Furniture, Depreciation of, 194
Future Deliveries, dangers of anticipating profits on, 181
Gas companies, accounts of, Points in audit of, 139
" " Forms, 401, 436
General accounting, examination questions, 511
Gold Mines, &c., accounts of, Points in Audit of, 112
Goodwill, Depreciation of, 190
" in accounts, Treatment of, 190
" Meaning of, in Balance Sheet, 190
Governmental supervision, 273
Gross Profit, Meaning of term, 211
" " use in checking stock accounts, 71
Heat and Power Companies, Forms, 400, 427
Hire-purchase agreements, 185
" " Depreciation of plant under, 194
Holding Companies, Consolidated Balance Sheets in connection with, 241
Horses, Depreciation of, 191
Hospitals, Points in audit of, 158
Hotels, accounts of, Points in audit of, 98
Hutchinson & McElheny v. American Malting Co., decision, 386
Imprest system of petty cash, 56, 62
Income and capital, Apportionment of, in Executorship Accounts, 155
Individual, Position of auditor to an, 276
Inspection of Minute Book, 201
" securities, 117, 162
Instalment system of depreciation, 188
Instructions as to general system of accounts, 57
" " " preparation for audit, 88
" for audit, 17, 20
Insurance Company, Amount of reserve necessary for, 121
" Companies, accounts of, Points in audit of, 121
" " Corporation Tax Law, 561

Insurance Companies, Life, Forms, 405, 463
" funds in shipping companies, Limitations of, 150
Interest and discount, Treatment of, 61
" Calculation of, 342
" or dividends, Audit of payments for, 51
" Rules governing, 355
Internal check, system of, Essential points in, 56
Interstate Commerce Commission, powers of, 133
Investigation, Extent of certificate after, 317, 324, 337
" Length of period to be covered by, 325
" Limits of an, 321
" Method of procedure in an, 325
" on behalf of a projected company, 320
Investigations as to profits, Adjustments of profits in, 332
" " " Comparison of Revenue Accounts in, 327
" " " Examination of Revenue Accounts in, 327
" " " Exceptional losses and profits in, 334
" " " Extent of, 316
" " " General course of procedure in an, 327
" " " Inspecting Balance Sheets in, 327
" " " Method of dealing with bad debts in, 331
" " " Method of dealing with depreciation in, 331
" Detection of errors in books in, 317
" " " fraud in, 322
" Opinion of accountants on extent of, 319
" Purposes for which, are made, 315
Investment Companies, Accounts of, Points in audit of, 124
" Fluctuation Accounts, Meaning of, 232
" of Reserve Funds, 236
Investments, Depreciation of, 191
" in Balance Sheet, Treatment of, 223
" " stocks and shares, Verification of, 175
" Valuation of, in audit of Investment Companies, 126
Invoices for purchases, Danger of "dating-forward," 183
Irish Woollen Company, Lim., case considered, 300, 367
Journal, Method of vouching, 42
" Use of the, 41, 79
Kingston Cotton Mills, case considered, 295, 363
Land and buildings, Verification of, 174
Landlord's fixtures, Depreciation of, 196
Lands, Depreciation of, 189
" on lease, Depreciation Fund necessary, 191
Lawyers, Accounts of, Points in audit of, 164
Leasehold land and premises, Depreciation of, 191
Leases, Depreciation of, 66

Ledger, Advantages of making each self-balancing, 66
" doubtful debts, Explanation of, 77
" Tabulation of the, 48
Ledgers, Accounts for which Tabular, are suitable, 67
" Comparison of, with previous Balance Sheet, 32
" Purchase, of retailer, Audit of, 93
" Sales, of retailer, Audit of, 92
" Self-balancing, 47, 57, 66, 83
" Tabular, 68
Lee v. Neuchatel Asphalte Company, Lim., case considered, 247
Leeds Estate Building and Investment Society v. Shephard case considered, 310, 358
Legislative requirements, 280, 296
Length of period to be covered by investigation, 325
Liabilities and assets in Balance Sheet, reason for transposing, 217
" Contingent, Verification of, 184
" in Balance Sheet, Treatment of contingent, 238
" " " " general, 226
" of auditors, 27, 290
" outstanding, Verification of, 183, 230
Liability, auditors for libel, 305
" Civil, of auditors, 309, 356
" Criminal, of auditors, 307
" Insurance Companies, Accounts of, 125
" of auditor of a bank, 114
" " with regard to predecessor's errors, 33
Libel, Liability of auditor for, 305
Life Insurance Companies, accounts of, Points in audit of, 124, 225
" " " Forms, 405, 463
" " " Reserve fund of, 232
Limitations of audit, 272
" Tabular Ledgers, 68
Limits of an investigation, 321
" to auditor's liability, 312
Liquidating Partners, Duties of, 337
List of books, preparation of, 24
" statistical books which companies should keep, 52
Localization of errors in Trial Balance, 47, 79
London and General Bank case as to auditor's responsibility for values, Decision in, 173, 293, 358
London Oil Storage Co., Lim., v. Seear, Hasluck & Co., with regard to verification of cash in hand, Decision in, 303, 373
Loose-Leaf System of bookkeeping, 70
Lubbock v. British Bank of South Africa, Lim., case considered, 248
Machinery and plant, Verification of, 177

Machinery, Depreciation of, 192
Magazines, accounts of, Points in audit of, 107
Manufacturers, accounts of, Forms of, 212, 407, 484
Manufacturing and trading profits, Distinction between, 172
" Corporations, Corporation Tax Law, 565
" traders, accounts of, Points in audit of, 92
Martin v. Isitt, case considered, 299, 374
Mechanical bookkeeping, 40, 84
Medical men, accounts of, Points in the audit of, 166
Mercantile Corporations, Corporation Tax Law, 562
" Enterprises, Forms, 407, 484
Merchants, Wholesale, accounts of, Points in audit of, 91
Meter rents, Method of vouching income from gas rates and, 140
Mines, accounts of, Forms of, 215
" " Points in audit of, 109
" Depreciation of, 110, 193
Mining Accounts, Definition of minimum or dead rents in, 109
Minute Book, Auditor's duty, who is refused permission to inspect, 201
" " Inspection of, 53, 201
" " Liabilities recorded therein, 184
" " of company, Auditor's right of inspection of, 201
Montgomery, Robert H., Accounts of Public Service Corporations, 134
" " Accounts of New York City, 154
Mortgages, Treatment of, in Balance Sheets, 227, 231
Moxham v. Grant case considered, 313
Municipal accounts, 152
" ownership, 132, 152
" reports, Forms, 410, 421, 497
National Banks Reports, 404, 455
"Net Profit" and "Profit safely divisible," distinction between, 264
" " meaning of term, 216, 252
Newspapers, accounts of, Points in audit of, 107
Newton v. Birmingham Small Arms Co. decision, 377
New works in place of old, Treatment of expenditure on, 137
Nicholson's, Trustee, &c., case, 317
Notes payable, Vouching of, 44
" promissory, Calculation of interest on, 342
" receivable, Vouching of, 44
Object and scope of an audit, 22
" of investigations, 315
" Revenue Accounts, 209
Official auditors, Duties of, 271
Opinion of accountants on extent of investigations, 319
Outstanding Assets, 182
" discounts, 198

Outstanding liabilities, 183
Partners, Auditor's duty as regards individual, 277
" retiring, Duties to, 338
Partnership agreement, Points to be considered in drawing up, 85
" agreements, 85
Pass Books in bank audit, Examination of, 116
Patents, Depreciation of, 194
Payment of dividends out of capital, What is, 248
Payments for dividends or interest, Audit of, 51
Pennsylvania C. P. A. questions, 513
" Legislature, Bill introduced in 1905 session, 280
Percentage of profits, Method of calculating, 73
Periodicals, Accounts of, Points in audit of, 107
Petty Cash Book, Method of keeping, 38, 62
" " Imprest system of, 57, 63
" " Method of vouching, 38, 94
" " payments, Treatment of, 63
Plant and machinery, Verification of, 177
" brewery, Depreciation in connection with, 96
" Depreciation of, 194
" Necessity of increased depreciation of electric lighting, 142
" theatrical, Depreciation of, 195
Postings, Calling back, 29
Power Companies, Forms, 400, 427
Preliminary expenses, Capitalization of, 172, 200
" " in accounts, Treatment of, 104, 200, 264
" " Vouching of, 200
Premium income of insurance office, Method of vouching, 123
Premiums received on issue of shares, Treatment of, 49, 202
Preparation for audit, Instruction as to, 88
Previous Balance Sheets, Treatment of, 32
Principal, Duties of, at commencement of new audit, 21
Principles in valuation of assets, 169
" of compiling a Balance Sheet, 168
" of valuing work in progress, 179
"Privilege" of auditor, 306
Procedure by way of action against auditors, 310
" on division of estate between beneficiaries, 155
Professional auditors, 269
" " number in United States, 269
" ethics, 380
Profit and Loss Account, consolidated, 239
" safely divisible and "Net profit," Distinction between, 264
Profits available for dividend, 386
" Definition of term, 254, 255

Profits Distinction between various classes of, 258
" Extent of investigations as to, 316
" from commission on underwriting shares, Treatment of, 259
" in investigations as to profits, Adjustments of, 332
" Method of calculating percentage of, 73
" of Public Service Corporation, paper on, 134
" on sales of investments, Treatment of, 127
" Testing if, are safely divisible, 264
Promissory Notes, 44
Prospectus of company, Necessity of perusing, 53
Provision for bad and doubtful debts, 196
" " debts by percentage of sales, 77
Public Authorities, Accounts of, Points in audit of, 152
" Service Corporations, Accounts of, Points in audit of, 132, 134, 152
" " " Corporation Tax Law, 563
" " " Forms, 399, 421
" " " Report on, Paper of R. H. Montgomery, read at St. Louis Congress of Accountants, 134
Published accounts, form of, Auditor's duty as regards, 206. 239
Publishers, accounts of, Points in audit of, 105
Purchase Ledger of retailer, Audit of, 92
Purchases, Danger of "dating forward" invoices for, 183
" Method of recording, 58
Qualifications of an auditor, 274
" audit clerks, 275
Questions C. P. A., 510
Quick Assets, 221
Railways, Steam, accounts of, Points in audit of, 143
" Street, accounts of, Points in audit of, 145
Receipts of revenue, 258
Redeemable stocks and bonds, Treatment of, 202
Removal of auditor, how effected, 284
Remuneration, Auditor's right to his, 276
Rent roll, Necessity of keeping proper, 64
Rents received and paid, Method of treating in accounts, 64
Reserve, Amount of, necessary for insurance company, 123, 235
" for depreciation and Reserve Fund, Distinction between, 217, 263
" Fund, 200, 232
" " Definition of term, 232
" " in Balance Sheet, Method of stating, 232
" " Investment of, 236
Reserves, regulation respecting same in English Companies Act, 253
" secret, Auditor's duty as regards, 204
" Treatment of, A. L. Dickinson on, 229
Resignation, Right of auditor as to, 282

Responsibility for values in Balance Sheet, 173
" of auditor for errors, 307
Restaurants, accounts of, Points in audit of, 99
Retailers, accounts of, Points in audit of, 92
Revenue account for traders, Form of, considered, 211, 408, 494
" " of bank, Points in, 119
" accounts in investigations as to profits, Comparison of, 327
" " Object of, 209
" and capital, Distinction between, 85, 109, 148, 386
" expenses, 260
" receipts, 258
Richardson v. Buhl decision, 257
Rights of auditors, 285
Salaries, Method of recording, 80
Sale of an undertaking to continuing partner, 337
" as a going concern, Definition of words, 169
Sales for future delivery, Treatment of, 181, 386
" " " " Verification of, 181
" Ledgers of retailer, Audit of, 92
" of investments, Treatment of profits on, 127
Saloons in connection with audit of brewery, 97
Savings Banks, audit of, 120
Schools and colleges, accounts of, Points in audit of, 160
Scope of an audit, object and, 22
Secret Reserves and assets, Fluctuations in, 203
Securities, Inspection of, 117, 154
Self-balancing Ledgers, 47, 57, 58, 66, 83
Share Capital Accounts, Audit of, 48
Shipping companies, accounts of, Points in audit of, 150
Ships, Depreciation of, 150, 152, 195
Short & Compton v. Brackett, Decision in, 319, 372
Sinking Fund, Explanation of, 233
" " in mining account, 110
" " system of depreciation, 189
" " to repay loans, Distinction between, and depreciation, 233
Smith v. Sheard, Decision, 376
Societies, building and loan, accounts of, Points in audit of, 161
Speculative finance companies, accounts of, Points in audit of, 126
Sprague, Chas. E., annuity tables, &c., 189
Staff, System of work of, 55
Statistical books, List of, which companies should keep, 52
" information, Advantages of, 215
Steam Railways, accounts of, Points in audit of, 143
" " Forms, 396, 411
Sterrett Jos. E. Professional Ethics, 380

Stock Accounts, Advantages of keeping proper, 71, 73, 74
" " in branch establishments, 84
" " Method of keeping, 71
" and Bonds Redeemable, Treatment of, 202
" and Share Accounts of companies, 75
Stockbrokers, accounts of, Points in audit of, 129
Stock-in-trade, Auditor's duty as regards valuation of, 174, 221
Stocks and shares, investments in, Verification of, 175
Stores and Stock accounts, Points in the audit of, 71
Street Railways, accounts of, Points in audit of, 145
Suspense Accounts, 76
System of books, Points to be considered in devising, 55
" " bookkeeping, necessity of mastering, 24
" " work of staff, 55
" on which an audit should be conducted, 17
Tabular Cash Book, Advantages of, 60
" Ledgers, 68
Tabulation of the Ledger, 47
Theatres, accounts of, Points in audit of, 101
Theatrical Companies, accounts of, Points in audit of, 103
" plant, Depreciation of, 195
Title Guarantee Insurance Companies, accounts of, 125
Trade and cash discounts, Distinction to be made between, 198
Traders, accounts of, Forms of, 211, 407, 484
" " " Points in audit of, 73
" manufacturing, accounts of, Points in audit of, 92
" Stock Accounts, 73
Trading and manufacturing profits, Distinction between, 172
Transportation Corporations, Corporation Tax Law, 563
"Tretyce off Housebandry," Extracts from, 440
Trial Balance, Importance of retaining books until, is audited, 45
" " Localization of errors in, 47, 79
Trust Companies, essential points in audit of, 121
Ultra vires acts, Auditor's duty as regards, 205
Uncompleted contracts, Valuation of, 182
Underwriting or placing of shares, Commission on the, 49
" shares, Treatment of profits from Commission on, 259
Usury, 345
Valuation of assets, Principles in, 169, 225
" copyrights, 105
" current assets, 172, 211, 262
" fixed assets, 171, 263
" investments in audit of investment companies, 126
" marketable investments, 224
" uncompleted contracts, 182

Values in Balance Sheet, Responsibility for, 173
Vouchers, Cancellation of, 42
" Definition of, 34
" Examination of, 34
Wages, Frauds in, 39
" Method of vouching, 39
Water companies, accounts of, Points in audit of, 141
" Supply Enterprises, Forms, 401, 441
Weiner v. Wurtemburg Electro Plate Company and another, case considered, 306
Wholesale merchants, accounts of, Points in audit of, 91
Wilde and others v. Cape and Dalgleish, Decision in, 299, 367
Wilkinson, George, Audit of insurance companies, 124
Wilmer v. McNamara & Co., Lim., 248
Work in progress, Verification of, 179

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